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**ABSTRACT**

The provision of Federal aid is more limited in United States territories and possessions than it is in the states. These areas are generally exempt from Federal taxes as an incentive to their economic self-reliance. This study analyzes the impact of extending full Federal aid and income taxes to these areas. Although Federal spending in these territories would double, more revenue would be generated from the taxes. This revenue may decline over time however, due to the loss of business tax incentives for American corporations with operations in the territories. Analysis of the considered change shows an increase in Federal costs in the territories and a decrease in their own costs. The leaders in these territories are not in favor of extending the Federal income tax. Some favored the extension of aid programs but expressed some concern about welfare dependency, work disincentives, and an influx of immigrants who want public assistance. Seventeen appendices and 21 tables cover descriptions of Federal programs, local demographics of the territories, and comments from United States and territory officials. (VM)

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United States General Accounting Office

Report to the Acting Chairman,  
Subcommittee on Public Assistance and  
Unemployment Compensation, Committee  
on Ways and Means, House of  
Representatives

September 1987

# WELFARE AND TAXES

## Extending Benefits and Taxes to Puerto Rico, Virgin Islands, Guam, and American Samoa



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Human Resources Division

B-220538

September 15, 1987

The Honorable Thomas Downey, Acting Chairman  
Subcommittee on Public Assistance and  
Unemployment Compensation  
Committee on Ways and Means  
House of Representatives

Dear Mr. Downey:

This report responds to the Subcommittee's request that we estimate the potential effects of fully extending selected federal welfare programs and income taxes to Puerto Rico, the Virgin Islands, Guam, and American Samoa.

We are sending copies of this report to Congressmen Harold E. Ford and Fortney H. (Pete) Stark, who requested the review; other interested House and Senate committees; the Secretaries of Agriculture, Health and Human Services, Interior, and Treasury; the Director, Office of Management and Budget; the governors, legislative leaders, and congressional delegations of the four areas; and other interested parties.

Sincerely yours,

Richard L. Fogel  
Assistant Comptroller General

# Executive Summary

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## Purpose

As requested by the House Ways and Means Subcommittee on Public Assistance and Unemployment Compensation, GAO analyzed the potential effects of fully extending Supplemental Security Income (SSI), Aid to Families with Dependent Children (AFDC), Medicaid, foster care, Child Support Enforcement, Food Stamps, and federal income taxes to Puerto Rico, the Virgin Islands, Guam, and American Samoa.

The United States treats these insular areas differently than states in providing federal aid and taxing income. Welfare coverage is generally more limited, leaving many needy individuals with less support, although it is sometimes more liberal than the states' counterpart programs. Area residents and businesses generally are exempt from federal taxes, and business tax incentives encourage the areas' economic self-reliance. Recently, there has been congressional interest in making welfare programs and income taxes more comparable between the areas and states.

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## Background

For decades, the federal government has fostered social and economic development in the areas through welfare programs and special tax treatment. Some of the six programs GAO analyzed operate in the four areas, but federal funding and sharing rates often are lower and program requirements different than in the states. SSI is not available in the areas, although some have counterpart programs; only the Virgin Islands and Guam have Food Stamps, although Puerto Rico's Nutrition Assistance Program is patterned after Food Stamps; and American Samoa has only Medicaid.

U.S. corporations, by using the U.S. Internal Revenue Code's section 936 tax credit or foreign tax credit, pay reduced or no federal taxes on their area income. Also, area businesses and residents are exempt from U.S. taxes on their area income, but such income is subject to local income taxes, which are patterned after federal taxes.

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## Results in Brief

Using 1984 data, GAO estimates that federal expenditures in the four areas would have doubled—from about \$1 to \$2 billion—had the six programs been fully extended to those areas. Federal increases would result from higher benefits, more recipients, and greater cost sharing. Conversely, areas' costs would have decreased about 37 percent—from \$244 to about \$154 million, due to full federal funding of SSI, lower cost sharing, and fewer Medicaid participants than the areas' counterpart



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Medicaid programs. Most area leaders favored extending SSI, but views on the other programs varied.

GAO estimates from 1983 data—the latest available—that federal tax revenue, negligible in 1983, would have been about \$2.7 billion more and area tax revenue \$1.4 billion less if federal income taxes had been fully extended and replaced area income taxes. But, because such changes could adversely affect local business activity, GAO believes annual federal tax revenue could decline significantly over the long term as some businesses close, relocate, or down-size operations after tax incentives disappear. Nearly all area leaders strongly opposed federal income taxes, citing the likely flight of businesses and other taxpayers and depressed economies—which in turn could lead to more welfare costs and less area tax revenue.

Because of their susceptibility to variation, GAO advises caution in using the interdependent cost and revenue estimates, as well as their overall net effect.

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## GAO's Analysis

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### Federal Costs Would Increase

Comparing 1984 actual with estimated program costs shows that federal cost increases would have differed by program and area. SSI would cost about 27 times more than the areas' counterpart adult assistance programs, due to full federal financing of benefits and higher participation under more liberal eligibility criteria. Federal AFDC costs would increase about 1-1/2 times, due to increased federal cost sharing and higher participation under more liberal eligibility criteria. Medicaid costs would increase nearly 5 times—assuming areas' costs would eventually approach states' costs—due to higher federal cost sharing and removal of federal funding ceilings. Federal costs for Food Stamps, already extended to the Virgin Islands and Guam, would increase about 25 percent if extended to American Samoa and Puerto Rico—mostly due to removing the federal funding ceiling on Puerto Rico's Nutrition Assistance Program.

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### Areas' Costs Would Decrease

Areas' costs would decrease, mainly because (1) with SSI, their adult assistance program costs would shift to the federal government and (2) the number of Medicaid participants would decrease about 34 percent

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under more restrictive eligibility criteria. Puerto Rico would have the greatest decrease—about \$88 million, or 38 percent.

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**Representatives' Views on  
Extending Programs  
Varied**

Most area leaders surveyed by GAO favored extending SSI and many favored extending AFDC, Medicaid, and Food Stamps, but not foster care. They saw (1) more adequate benefits, (2) better services, and (3) fairer treatment for residents. They were concerned about (1) welfare dependency and work disincentives, (2) immigration from neighboring islands to obtain assistance, and (3) disruption of their area cultures, particularly in American Samoa.

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**Federal Income Tax  
Revenue Increases Might  
Decline Over Time**

Expected revenue from extending federal taxes would result mainly from eliminating section 936 credits for U.S. corporations operating in Puerto Rico. GAO estimates that in 1983, federal corporate tax revenue from the four areas would have been about \$2.14 billion and personal tax revenue about \$531 million, but believes that—mostly because of the loss of business tax incentives—over the long run annual federal revenue could decline to less than \$2.1 billion.

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**Areas' Tax Revenue Would  
Decrease**

Areas would have lost about \$524 million in corporate and \$892 million in personal tax revenue had U.S. taxes replaced area taxes. Estimated federal corporate tax revenue is higher than area losses because federal tax law would not have allowed all of the areas' tax systems' exemptions and rebates. Estimated federal personal tax revenue is lower than area losses mostly because federal income taxes are lower than some areas' taxes.

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**All Areas Oppose  
Extending Taxes**

Business leaders and nearly all area officials opposed extending federal taxes because, they told GAO, businesses would relocate, revenues and jobs would diminish, and the need for welfare would increase, as would areas' fiscal dependence on the United States. Some were concerned about taxation without representation, and the Puerto Rico governor and other officials there questioned whether, without area concurrence, the United States legally could impose taxes on their area—an issue involving U.S./Puerto Rican political relationships.

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## Estimates Subject to Variation

Many factors could affect GAO's estimates, including (1) areas choosing different designs for fully extended programs than were envisioned during GAO's review, (2) changes in areas' economies or business activities that affect the demand for welfare services or potential income tax revenue, and (3) recent and future legislative changes. Thus, GAO advises caution in using the estimates.

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## Matters for Congressional Consideration

There are inherent uncertainties in predicting the effects of fully extending welfare and, particularly, taxes to the areas. Should the Congress endeavor to make changes in the programs or taxes, it should consider:

- Extending one program at a time to an area or subarea on an experimental basis and determining the actual costs and the extent and nature of other effects. Area views would help in selecting experiments.
- Gradually increasing corporate tax revenues (such as by decreasing section 936 credits) up to the cost of the program extension, rather than eliminating business tax incentives altogether.

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## Agency Comments

GAO received comments from Puerto Rico's governor, Senate president, and resident commissioner; the Virgin Islands' governor; Guam's speaker of the Legislature; American Samoa's governor and Senate president; and the U.S. Departments of Agriculture, Treasury, Interior, and HHS. (See p. 74-80.)

Area officials generally restated their positions—as discussed in the report—on fully extending welfare programs. Also, all area officials restated strong opposition to fully extending federal income taxes, reemphasizing the likelihood of reduced business activity, increased unemployment, and the consequent need for more welfare.

Agriculture said GAO downplayed the significance of Food Stamps in the areas and the Nutrition Assistance Program in Puerto Rico. Treasury said that GAO's long-term estimate of the revenue effects of tax extension should be deemphasized. GAO, however, believes the report properly characterizes these matters. Interior opposed any policy that would extend additional programs or taxes, citing its interest in having area residents attain self-government and plan their own futures. HHS said the report was a fair and accurate portrayal of its programs in the areas.

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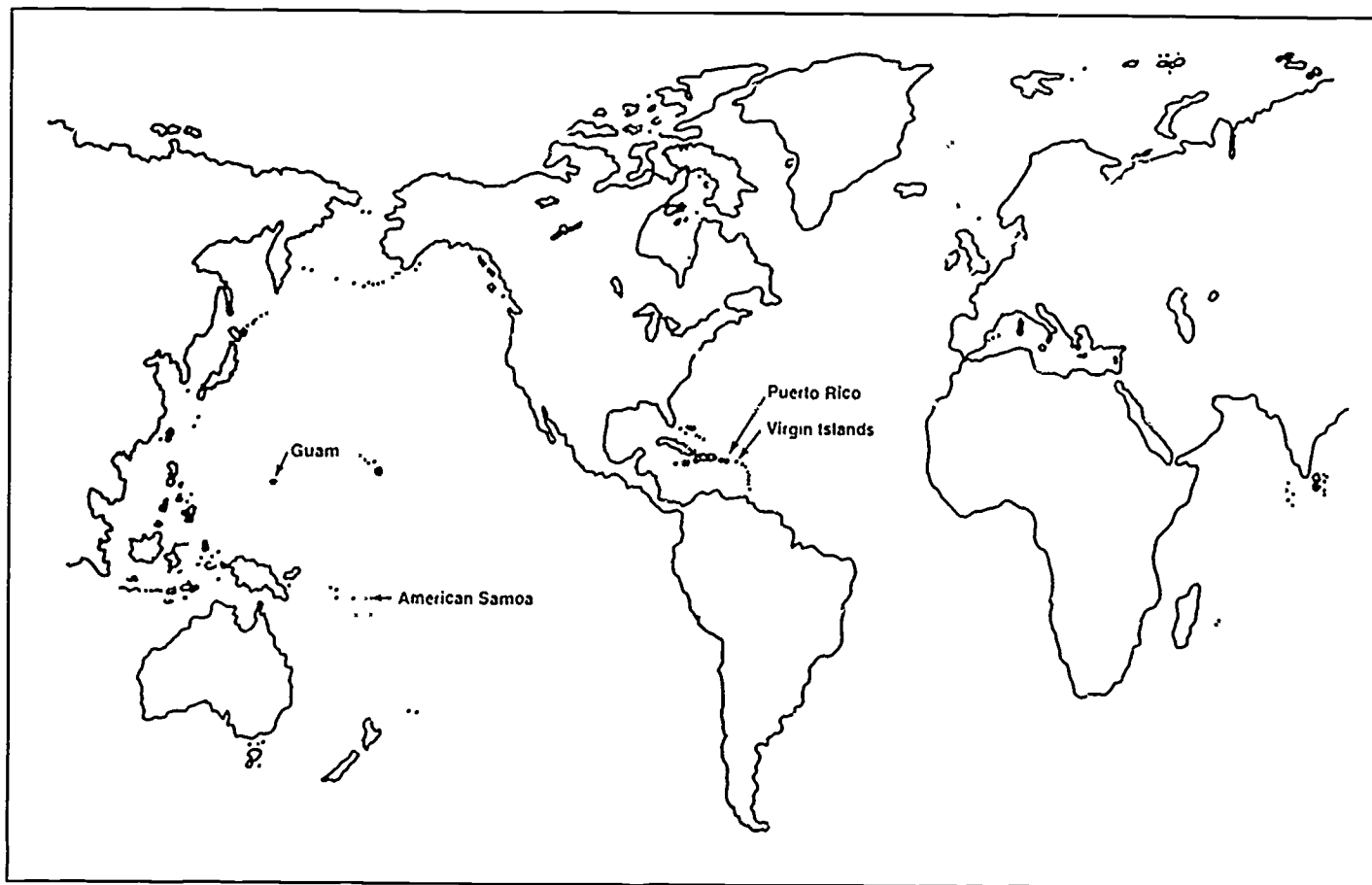
Abbreviations

AFDC	Aid to Families with Dependent Children
GAO	General Accounting Office
HHS	Department of Health and Human Services
SSA	Social Security Administration
SSI	Supplemental Security Income
TEFRA	Tax Equity and Fiscal Responsibility Act of 1982

# Introduction

The United States provides financial and other assistance to its territories and possessions, which in the Caribbean include the Commonwealth of Puerto Rico and the Virgin Islands and in the Pacific, Guam and American Samoa (see figure 1.1). Historically, these "insular areas" have depended heavily on federal programs and such other forms of assistance as special tax treatment. The need for such treatment stems in part from factors limiting the areas' ability to attain economic self-sufficiency and social development. These factors—varying in applicability among the areas—include scant natural resources, geographic remoteness from major world markets including the U.S. mainland, small land areas and populations, and limited investment capital.

Figure 1.1: U.S. Territories and Possessions



Over the years, the United States has contributed to the social development of the areas by extending federal assistance programs. It has supported schools, hospitals, housing, and other infrastructure projects. In addition, grant programs have provided resources that enable the areas to deliver various social services.

In some cases, grant programs are extended differently to the areas than to the states. Often the historical reasons for different treatment are not readily discernible. Sometimes programs were tailored to meet special area needs and circumstances. For example, under federal law that authorizes the Secretary of Health and Human Services (HHS) to waive most Medicaid requirements for American Samoa, a unique program was established to meet the area's needs.

Long-standing federal policy also has aimed at fostering the areas' fiscal autonomy and economic self-reliance. For several decades, area residents and corporations have been exempted from federal taxes on income earned in the areas, and area governments have been allowed to retain the proceeds of area taxes. Also, as early as 1954 special tax incentives were enacted to encourage U.S. businesses to locate and otherwise operate in the areas, thus helping to enhance the areas' economies.

There were significant demographic and economic differences among the four areas in 1984—the general base period for our study (see table 1.1). For example, Puerto Rico's population of 3.3 million dwarfed those of the other three areas. Likewise, Puerto Rico's labor force of 953,000 was almost 10 times larger than the combined labor forces of the other three. American Samoa had the smallest labor force—about 11,900.



**Table 1.1: Selected Characteristics of the Four Insular Areas**

Characteristic	Puerto Rico	Virgin Islands	Guam	American Samoa
Population <sup>a</sup>	3,270,000	107,500	112,100	35,300
Labor force	953,000	43,470	44,389	11,936
Number employed	742,000	40,230	41,569 <sup>b</sup>	10,400
Number unemployed	210,000	3,240	2,800	1,536
Unemployment rate (percent)	22	7.5	6	12.9
Per capita income	\$4,096	\$7,455	\$7,504 <sup>c</sup>	\$3,270

<sup>a</sup>July 1984 estimate. Civilian population shown for Guam, no active-duty U.S. military personnel included.

<sup>b</sup>An employee was counted at each place employed. Thus, if employed by two or more employers, the employee would be counted more than once.

<sup>c</sup>Excludes military salaries.

Puerto Rico had the highest unemployment rate, averaging 22 percent in 1984—from a 1983 high of 23.5 percent. Guam's rate, 6 percent, was the lowest, partly because it reflected approximately 10,000 active-duty U.S. military personnel. (Guam's rate was close to 8 percent when military personnel were excluded). Per capita income also varied widely among the areas, with American Samoa having the lowest per capita income and Guam the highest.

Additionally, the areas are unique culturally and politically, both from the 50 states and from each other. Puerto Rico, whose Spanish heritage is evident in its vernacular language, architecture, and culture, is unique in that the area's political relationship with the United States permeates virtually all public policy, economic, and social issues. Guam is characterized by an extensive U.S. military presence, which covers much of its land area and directly influences the area's economy. American Samoa, the only area whose residents are not U.S. citizens but U.S. nationals, has a culture based on the tightly knit extended family, which affects not only its economy but also its demands for social services.

Each of these areas is represented in the U.S. House of Representatives by a resident commissioner (Puerto Rico) or delegate who can vote in committee but not on the floor. Its residents provide delegates to U.S. political party conventions, but do not vote in presidential elections.

Over the years, attempts have been made in the Congress to remove some of the differences in program and tax treatment between the areas and the states. For example, bills have been introduced, but not enacted, to extend SSI as it exists in the states to the areas. In a similar way,

attempts have been made to reduce or eliminate special tax treatment for the areas. For example, a proposal that led to the Tax Reform Act of 1986 provided for repealing the major tax incentive for U.S. businesses operating in the areas. This proposal was not adopted.

Noting the interest in extending certain federal programs to areas where they do not exist or are extended differently than in the states and the lack of adequate information upon which to legislate, the chairman and the ranking member of the House Ways and Means Committee's Subcommittee on Public Assistance and Unemployment Compensation asked us to determine the possible effects of fully extending selected major welfare programs and income taxes to the four areas. As agreed, the programs included in our review were:

- Supplemental Security Income (SSI) - Cash assistance directly provided by the federal government to aged, blind, or disabled individuals meeting federally established income, resource, and other requirements.
- Aid to Families with Dependent Children (AFDC) - Grants providing cash for children in single-parent families or—at state/area option—certain two-parent families that meet state/area established income, resource, and other eligibility requirements.
- Medicaid - Grants for providing medical assistance to the “categorically needy”—primarily persons eligible for SSI and AFDC—and other low-income individuals, including the “medically needy”—persons whose income is too high to qualify for SSI, AFDC, adult assistance, or other cash assistance, but after deducting incurred medical expenses is below the state/area assistance standard.
- Foster care - Grants for providing food, clothing, and other services for children living away from home when both parents are incapacitated, absent, or otherwise unable to provide adequate care. Federal funds are available under Social Security Act titles IV-B, IV-E, and XX. To receive assistance, recipients must meet state/area eligibility requirements for each title.
- Child Support Enforcement - Grants for administering the enforcement and collection of support obligations owed by absent parents.
- Food Stamps - Grants providing food coupons to help ensure nutritious diets for families meeting federally established eligibility requirements.

## Availability of Selected Welfare Programs in the Four Areas

Five of the six federal programs currently operate in some form in most of the areas, but some programs, as shown in table 1.2, are not available in every area.

Table 1.2: Federal Program Availability in the Four Areas

Program	Puerto Rico	Virgin Islands	Guam	American Samoa
SSI	N <sup>a</sup>	N <sup>a</sup>	N <sup>a</sup>	N
AFDC	Y	Y	Y	N
Medicaid	Y	Y	Y	Y
Foster care	Y	Y	Y	N
Child Support Enforcement	Y	Y	Y	N
Food Stamps	N <sup>a</sup>	Y	Y	N

Y - Yes

N - No

<sup>a</sup>Counterpart programs with similar objectives but different program features are available.

When established, SSI was not extended to the four areas. According to statements of the Senate Finance Committee chairman (Congressional Record, March 11, 1976), the Congress thought it inadvisable to provide the guaranteed SSI income levels to areas whose economies were significantly different than those of the states. Instead of this 100-percent federally funded and administered program, the Congress continued the areas' "adult assistance" programs, which provide cash assistance to needy aged, blind, or disabled persons. In the states, the adult assistance programs were replaced in 1974 when SSI went into effect.

Under the adult assistance programs, eligibility requirements and benefit levels are set by the areas, and the federal government pays only part of the program costs. Federal law limits total federal funds available for the areas' combined expenditures for the adult assistance programs, AFDC, and title IV-E foster care maintenance payments for children who have no caretaker relative but otherwise are eligible for AFDC. Similarly, federal expenditures on Medicaid in the areas are capped. The current federal funding limits on these programs are shown in table 1.3.

**Table 1.3: Federal Funding Limits for Area Welfare Programs**

Dollars in millions		
Area	Funding limit	
	Combined adult assistance, AFDC, & title IV-E foster care <sup>a</sup>	Medicaid <sup>b</sup>
Puerto Rico	\$72.00	\$63.40
Virgin Islands	2.40	2.10
Guam	3.30	2.00
American Samoa	Not applicable	1.15

<sup>a</sup>Current limits have been in effect since 1977.

<sup>b</sup>Current limits have been in effect since 1984.

The federal government reimburses the areas for their AFDC program expenditures at rates lower than state rates. The maximum federal sharing rate for the areas is set by federal law at 75 percent. While states have the option to seek AFDC reimbursement under different formulas, all have opted to use the Medicaid rate, which can be as high as 83 percent.

Among the six programs, only Medicaid is extended to each area. Along with funding ceilings, there are lower federal reimbursement rates and other substantial differences between Medicaid programs in the states and those in the areas. Most notably, the areas have waivers to the requirements that the income of "medically needy" participants generally cannot exceed 133-1/3 percent of the applicable AFDC payment standard. Also, the program's "freedom of choice" requirements historically have been waived for the areas. (That is, area participants cannot select medical service providers.) States were given authority to seek waivers to this provision beginning in fiscal year 1982.<sup>1</sup>

Foster care financing similar to that in the states, except for funding limits on title IV-E, is available to Puerto Rico, the Virgin Islands, and Guam.

The Child Support Enforcement Program operates in each of the areas (except American Samoa) as it does in the states.

Food Stamps operates in the Virgin Islands and Guam as it does in the states. It was not extended to American Samoa. In 1982, the program was replaced in Puerto Rico by the Nutrition Assistance Program as part

<sup>1</sup>The waiver authority for states was provided under the Omnibus Budget Reconciliation Act of 1981 (42 U.S.C. 1396n).

was replaced in Puerto Rico by the Nutrition Assistance Program as part of an effort to reduce federal costs. Puerto Rico's program, which serves almost half the area's total population, has the same basic objective as Food Stamps, but there are substantial differences. The Food Stamp Program has an "open-ended" authorization (no federal funding ceiling), while Puerto Rico's program had an \$825 million federal funding ceiling from 1983 to 1986. (Maximum authorized amounts for subsequent fiscal years are progressively larger, ranging up to \$936.8 million in fiscal year 1990.) But the Nutrition Assistance Program may be somewhat more flexible in that Puerto Rico is authorized, within limits of federal law and regulations, to establish program eligibility criteria, benefit levels, and administrative procedures and to provide benefits in cash rather than coupons.

Details about the programs are provided in appendix I.

At the federal level, HHS administers all programs except Food Stamps and Puerto Rico's Nutrition Assistance Program, which the Agriculture Department's Food and Nutrition Service administers. Within HHS, the Social Security Administration (SSA) administers SSI; the Family Support Administration<sup>2</sup> administers the adult assistance, AFDC, and Child Support Enforcement programs; the Health Care Financing Administration administers Medicaid; and the Office of Human Development Services administers foster care programs authorized by the Social Security Act. Federal agencies' responsibilities for the areas vary by program, but generally entail such functions as reviewing and approving the areas' plans, allocating and awarding funds, and monitoring compliance with federal laws and regulations.

Except for specific programs, the Department of the Interior is responsible for administering most areas. The Department, primarily through its International and Territorial Affairs Office, is charged with providing technical assistance, presenting the areas' budgets before the Congress, and promoting the economic, social, and political development of the Virgin Islands, Guam, and American Samoa. Puerto Rico is not under the jurisdiction of any federal agency.

<sup>2</sup>The Family Support Administration became functional on April 1, 1986. Until that time, SSA administered the adult assistance and AFDC programs, and the Child Support Enforcement Program was administered by the Office of Child Support Enforcement, within the Office of the Secretary.



## Special Federal Tax Treatment for the Four Areas

To provide the four areas with operating revenues and encourage business investment, the federal government allows them special income tax treatment. Generally, area residents and corporations are exempt from federal income taxes on part or all of their income, but pay area income taxes, which in many respects are similar to U.S. income taxes. These arrangements were intended to give the areas a measure of fiscal autonomy and in some cases avoid annual appropriations against the U.S. Treasury.

For federal income tax purposes, Puerto Rican citizens are taxed on worldwide income, the same as other U.S. citizens. But full-year residents of Puerto Rico, except federal employees, are exempt from federal taxes on income earned in Puerto Rico. Similarly, Puerto Rican corporations are exempt from federal tax on Puerto Rico-source income, but pay federal taxes on all other income. All Puerto Rican residents and corporations are subject to Puerto Rico's income tax, and U.S. residents and corporations are subject to Puerto Rican income tax on Puerto Rico-source income.

In 1983, the Virgin Islands and Guam organic acts<sup>3</sup> required them to operate income tax systems that precisely followed the U.S. Internal Revenue Code. This is referred to as the "mirror" principle of taxation. American Samoa opted through its own laws to "mirror"—with certain exceptions—the Code. As a result, the three areas' income tax systems were nearly identical to the federal income tax system, except as specified by area law in American Samoa's case or otherwise by federal law.

The Code provides special income tax treatment to U.S. corporations operating in the areas to foster business investment in the areas. Most notably, qualifying corporations operating in Puerto Rico, Guam, and American Samoa (and, after 1986, the Virgin Islands) may claim a dollar-for-dollar credit against federal income tax liability on income derived from these and certain other U.S. areas. This credit, the "Puerto Rico and Possessions Tax Credit," was established by the Tax Reform Act of 1976 as section 936 of the Code, and is often referred to as the

<sup>3</sup>Organic legislation is federal law that establishes the legal framework for governing insular areas. Under the Tax Reform Act of 1986, Guam is authorized to develop its own income tax laws.

"section 936 credit."<sup>4</sup> The credit replaced special provisions, dating back to 1921, under which corporations had been exempted from U.S. income taxes on profits earned in insular areas. To qualify, corporations must derive at least 80 percent of gross income from these areas, and at least 75 percent of gross income from active trade or business conducted in the areas.<sup>5</sup> Corporations opting for this credit generally must do so for a minimum of 10 years.

U.S. corporations claiming the section 936 credit qualify for other special income tax treatment. They may repatriate (send back to the United States) dividends to their parent corporations free of tax, because their parent corporations generally are entitled to a 100-percent deduction for dividends received. This contrasts with the 85-percent deduction generally available to U.S. corporations.<sup>6</sup>

The corporations also qualify for special federal income tax treatment for income from intangible property such as patents, formulas, and copyrights. Generally, when intangible property is transferred to a controlled foreign corporation, the transferor must recognize as income any profits earned on this property by the foreign corporation. When intangible property is transferred to a subsidiary in an area, however, a portion of these profits, upon election, may be recognized by the subsidiary, or a portion of associated research and development costs may be recognized by the parent corporation. Either treatment essentially reduces the taxable income of the transferor and increases the subsidiary's tax-free income.

Unlike corporations that qualified for the section 936 tax credit, in 1983 U.S. corporations' Virgin Islands' subsidiaries could not repatriate dividends free of tax, because their parent corporations generally were entitled to only the 85-percent dividends-received deduction. Virgin Islands

<sup>4</sup>While the term "possessions" may include Puerto Rico, the Virgin Islands, Guam, American Samoa, and various other U.S. territories and insular possessions for federal income tax purposes, the Virgin Islands was not considered a possession for purposes of this tax credit prior to the Tax Reform Act of 1986. The Tax Reform Act of 1986 applied section 936 to the Virgin Islands for tax years after 1986. From 1954 to 1986, Virgin Islands inhabitants, including some U.S. corporations, satisfied their U.S. income tax obligations by paying taxes to the Virgin Islands.

<sup>5</sup>The gross income requirement for active trade or business, as opposed to interest and other passive income, was increased from 50 to 65 percent by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). The increase was phased in over a 3-year period beginning in 1984. The requirement is increased to 75 percent, effective in 1987, under the Tax Reform Act of 1986.

<sup>6</sup>Under the Tax Reform Act of 1986, corporations electing the section 936 credit may repatriate 90 percent of their profits tax-free, while most corporations may exclude 80 percent of dividends received from other corporations.

corporations were eligible for special treatment of intangible property income only when at least 80 percent of their gross income was derived from Virgin Islands sources and at least 65 percent from conducting active trade or business in the Virgin Islands.

The Code allows U.S. corporations operating in each area to claim the foreign tax credit for taxes paid to the area governments. This credit is limited to the total amount of U.S. tax liability related to foreign sources. It may not be taken jointly with the section 936 tax credit.

Although the areas' income tax systems were patterned after the federal tax system, each area allows the exemption of income from taxes or the rebate of part or all of the area income taxes, under certain circumstances. These and other differences, particularly in the Puerto Rican and American Samoan systems, can cause taxes paid by area taxpayers to differ considerably from what they would pay under unmodified federal income tax rules.

The areas administer their own tax systems. The U.S. Treasury Department's and Internal Revenue Service's involvement with the areas' income tax systems is limited to providing, upon request, training and technical assistance.

A more detailed overview of the areas' income tax systems is provided in appendix II.

## Objectives, Scope, and Methodology

Our objective was to determine the effects on the United States and the four areas of extending to the areas selected welfare programs and U.S. personal and corporate income taxes. Through discussions with the requesters' offices, we agreed upon the six programs to be included in the review and assumed that the welfare programs would replace existing federally supported counterpart programs in the areas. With respect to the tax issue, we assumed that (1) such special income tax treatment now available in the areas as section 936 and foreign tax credits would be eliminated, (2) area corporations and residents would be subject to U.S. income taxes, and (3) resulting tax revenues would be paid to the U.S. Treasury. We also obtained area officials' perspectives about the cost, revenue, and other effects of extending programs and taxes.

We did our work between February 1985 and August 1986. We gathered data from the headquarters and regional offices of the federal agencies

responsible for overseeing the areas, programs, and federal income taxes—the Departments of Interior, Agriculture, Health and Human Services, and Treasury. Also, we consulted with Bureau of the Census officials in the Department of Commerce about the availability and feasibility of using census data to develop program cost estimates. On-site work in the areas was done between July and December 1985.

To develop program cost estimates, we used income and population data from the 1980 census—the latest available for the areas. We supplemented these data to the extent possible with 1984 program and demographic data obtained from the federal and area agencies responsible for the six programs or their program counterparts. Also, we identified existing program cost estimates and to the extent possible obtained supplementary information directly from the federal and area officials who had compiled them. Further, we reviewed federal laws and regulations, area plans, federal and area reports, and other relevant documents.

Our program estimates reflect anticipated changes in program benefit and participant levels expected from federal program design requirements and program design options that area policy-making officials, as they reported to us, likely would elect. To determine which program options areas might elect were the six programs fully extended, we interviewed high-level area policy-making government officials, including the governors of the Virgin Islands, Guam, and American Samoa<sup>7</sup>; leaders and members of the area legislatures; and cabinet and department-level program and other policy-making officials.

Further, our estimates reflect interprogram linkages, where possible. For example, estimated Medicaid costs reflect estimated changes in SSI and AFDC participation rates because such participants would be eligible categorically for Medicaid. Similarly, our Food Stamp estimates reflect offsetting reductions in benefit amounts resulting from higher SSI and AFDC benefits. Food Stamp households receive the maximum amount of coupons allowed where they live, reduced by such countable income as AFDC and SSI benefits. Also, estimated Child Support Enforcement costs take into account estimated increased numbers of AFDC participants because such recipients must assign support rights to states/areas as a condition of eligibility. Correspondingly, AFDC cost estimates reflect offsetting adjustments for Child Support Enforcement collections from the absent parents of the increased numbers of AFDC-eligible families.

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<sup>7</sup>We did not have the opportunity to meet with the governor of Puerto Rico.

Details on our program cost-estimating methodology are provided in appendix III.

To develop tax revenue estimates, we reviewed relevant parts of the Code, other federal laws and regulations, and the areas' own laws, identifying differences between the U.S. and insular area income tax systems. We also interviewed and obtained documentation from area officials responsible for administering area income taxes to develop our understanding of their systems and identify adjustments to area tax liability needed to estimate U.S. tax liability and potential federal tax revenue. Our estimates were based on 1983 tax data<sup>8</sup>—the latest full-year tax data available for the areas.

We used the most reliable data available at the time of our work. Most of our tax estimates assume that areas' business activity and economic conditions in 1983 would remain the same and that the federal taxes would replace area income taxes, although some officials told us the areas might retain or impose some unspecified area income tax. We did not attempt to adjust our estimates for this possibility, because area officials provided no details on the likely tax schemes, and we had no basis for an adjustment. Should areas impose income taxes, federal revenue could be reduced to the extent that these taxes would be allowed to be deducted from federal income tax liability. Our federal revenue estimates reflect actual area experience for tax year 1983, with reconciling adjustments to convert areas' systems to the U.S. tax system for estimating purposes.

Because the tax changes doubtless would affect area business activity and hence economic conditions, we also estimated the possible effects of such changes on business activity in Puerto Rico—the largest of the four areas both economically and tax revenue-wise. We did this through (1) an analysis of several recent studies and (2) discussions with representatives of businesses operating in the areas. (See app. IV.)

Our detailed methodology for estimating income tax revenues is shown in appendix V. Appendix VI contains a list of recent studies relating to the effects of modifying taxes in Puerto Rico, relevant GAO reports, and other publications.

<sup>8</sup>Tax data for 1983 includes personal tax liability generally covering calendar year 1983 and corporate tax liability covering the tax reporting periods beginning between July 1982 and June 1983.



In addition to high-level government officials and business representatives, we sought perspectives from private interest groups and academicians in the areas on the potential social and economic effects of extending the federal programs and income taxes. We obtained their views on such matters as whether the new federal programs would supplant or supplement existing federally supported and area programs, and to what extent the need for matching and support funds for the new programs might burden area governments. We sought perspectives on how the new programs might affect such matters as individuals' general well-being, standards of living, family relationships, dependency on welfare, and migration into and out of the areas. We also sought views on the economic impact of fully extending U.S. taxes, particularly the possible effects on U.S. and other businesses operating in the areas. Finally, we explored with them some of the options available to compensate for operating revenue that would be lost if federal income taxes replaced area income taxes. These options included (1) imposing or continuing area income taxes similar to domestic state or local income taxes; (2) imposing or modifying sales, property, or other taxes; (3) adjusting expenditure plans, including reducing or eliminating current services; and (4) such others as issuing revenue bonds.

Some data used to develop program cost and tax revenue estimates had limitations. Area program and demographic data were often not available at the federal level or were outdated, incomplete, or not comparable with data available on the states' programs. For example, the latest census data on the areas were 1979 data, and the nature and completeness of census information varied by area. Additionally, we identified no useful information on potential clients' assets—a key factor in determining eligibility for SSI, AFDC, and Food Stamps. Also, because the areas are not required to submit reports on some of their programs to the federal agencies, program participant and cost data were sometimes absent or inconsistent with that available on the states' programs. Further, the lack of information on area or nationwide participation rates in some programs and the difficulty predicting which of the many variables associated with program options areas' might elect under fully extended programs made cost estimating very complex for some programs, particularly Medicaid.

Normally, the federal government does not collect tax information on area income taxes. As a result, area tax data at the federal level was

limited. At the area level, the nature and completeness of readily available tax information varied by area, but generally was limited.

Because of data deficiencies, we made assumptions in estimating certain program costs and revenues. These assumptions generally were based on empirical U.S. data. For example, we estimated the numbers of SSI participants in Puerto Rico and the Virgin Islands by assuming that the SSI participation rate in those areas was the same as the rate for states' residents with comparable incomes. Additionally, we estimated area Medicaid per-participant costs by assuming that such costs would approximate West Virginia's Medicaid costs—the lowest average-Medicaid-payment state. We also used U.S. experience in making certain tax revenue projections. For example, we used U.S. data on numbers of taxpayers itemizing deductions and the amounts of these deductions in estimating itemized deductions in Puerto Rico. The U.S. data, classified by filing status and income range, was applied to Puerto Rican data on numbers of taxpayers by filing status and income range. It was necessary to use U.S. data because of numerous differences in deductions allowed by Puerto Rico and the United States. Thus, certain of our revenue and program cost estimates would be affected to the extent that such assumptions prove inaccurate. Our assumptions are discussed more fully in appendices III and V.

Because of the lack of information on American Samoa, we assumed that all income-eligible residents of the area would participate in Food Stamps. This may result in a high estimate because some applicants may (1) not meet applicable resource requirements or (2) choose not to participate, although eligible. The Department of Agriculture estimates that about one-third of the income- and resource-eligible individuals in the states and other areas do not participate in the program.

Finally, our estimates reflect conditions in the areas at the time of our work. Thus, they are subject to change, given changes in the areas' economic, tax, or social policies and shifts in the areas' economies. Federal legislation affecting program or federal income tax system design, particularly the 1986 immigration and tax reform legislation, also would affect current and future year estimates. The Immigration Reform and Control Act of 1986 authorizes certain welfare benefits for aliens who were illegal and thus ineligible for certain program benefits prior to its enactment. The Tax Reform Act of 1986, although expected to be revenue-neutral over a 5-year period, is expected to increase corporate income tax revenue and decrease personal income tax revenue and thus redistribute tax burdens. Our estimates would be affected accordingly.

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Neither law has been in effect for a long enough period to determine its effects in the states or areas.

# Extending Federal Welfare Programs: Costs and Area Views About Effects

Fully extending SSI, AFDC, Medicaid, foster care, Child Support Enforcement, and Food Stamps to the four areas would have major cost effects. Had the programs been fully extended in 1984, we estimate that federal costs would have increased by \$1.049 billion and areas' costs decreased by \$90 million. The net result would have been about \$960 million more in program funds available for the areas. These effects stem from the design requirements of fully extended federal programs as well as the various program options that could, and as reported to us, likely would be elected by the areas. In effect, program benefit levels and the likely numbers of program participants would have increased.

## Effects on Program Costs

Federal and area cost changes would vary widely by program were the six programs fully extended, as table 2.1 shows. Both federal and area costs would increase for each program except SSI and Medicaid, we estimate. For these two, federal costs would increase while area costs would decrease. A program-by-program analysis of the estimated cost effects follows.

**Table 2.1: Costs of Welfare Programs in the Four Areas in 1984, and Estimated Costs If Programs Were Fully Extended**

Dollars in millions

Program	Costs <sup>a</sup>			
	Actual		Estimated, if fully extended	
	Federal	Areas	Federal	Areas
SSI/adult assistance	\$15.9	\$7.3	\$441.3	\$0
AFDC	57.2	23.0	143.0	33.5
Medicaid	68.8	186.8	402.0	84.8
Foster care	0.4	0.1	3.9	1.5
Child Support Enforcement	3.0	1.2	3.9	1.5
Food Stamps/Nutrition Assistance Program	862.5	25.1	1,063.6	32.2
Subtotal	\$1,007.8	\$243.6	\$2,057.6	\$153.5
<b>Total federal and area</b>	<b>\$1,251.3</b>		<b>\$2,211</b>	

<sup>a</sup>Some columns do not add due to rounding.

The cost changes result from several factors: the change in program participants (see table 2.2), shifts in costs because of higher federal reimbursement rates, and elimination of federal funding ceilings.

**Table 2.2: Participants in Welfare Programs in the Four Areas in 1984, and Estimated Participants If Programs Were Fully Extended**

Participants in thousands			
Program	Actual	Participants	Change
		Estimated, if fully extended	
SSI/adult assistance	40.9	161.7	120.8
AFDC	189.6	254.5	64.9
Medicaid	1,640.9	1,075.5	-565.4
Foster care (title IV-E only)	0	2.5	2.5
Child Support Enforcement	110.9	111.7	.8
Food Stamps/Nutrition Assistance Program	1,525.4	1,879.0	353.6

Note. The numbers of participants should not be totaled because a person may participate in more than one program.

## SSI

Had SSI been fully extended to the areas in 1984, federal costs for serving the aged, blind, or disabled would have increased by an estimated \$425.4 million, or 27-fold. The areas would have incurred no costs under SSI and would have saved the estimated \$7.3 million they spent in 1984. The total net increase in funds available to the areas to serve such clients would have been about \$418.1 million.

The higher federal and lower area costs primarily result from replacing the federally and area-funded adult assistance programs in Puerto Rico, the Virgin Islands, and Guam with the fully federally funded SSI program. For example, higher federal costs would result from eliminating the federal funding ceiling that exists on the combined adult assistance, AFDC, and title IV-E foster care expenditures in each of these areas.

Higher federal costs also result from SSI's higher benefit levels and the numbers of additional persons who would be eligible to participate in the program. Because SSI's maximum monthly benefits are much higher than the maximum benefits of the areas' adult assistance programs, persons with higher incomes would qualify for SSI. We estimate that in 1984, 121,000 persons—in addition to the 41,000 served by adult assistance programs in Puerto Rico, the Virgin Islands, and Guam—would have participated in SSI. Our estimate includes about 980 persons who would have been assisted by SSI in American Samoa, which did not have an adult assistance program.



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## AFDC

Had AFDC been fully extended to the areas in 1984, federal costs of serving dependent children and their caretakers would have increased an estimated \$85.8 million, or about 150 percent, and area costs about \$10.5 million. Combined 1984 costs would have increased by over \$96.3 million.

Fully extending AFDC would eliminate the federal funding ceilings on combined AFDC, adult assistance, and title IV-E foster care expenditures in Puerto Rico, the Virgin Islands, and Guam. Thus, the areas would have more funds to pay higher benefits, which in turn could increase program participation. Officials in each of these areas told us they would increase benefit payments were AFDC fully extended. Thus, we estimate that in 1984, 65,000 persons would have participated in AFDC in addition to the 190,000 served under modified AFDC programs in Puerto Rico, the Virgin Islands, and Guam. Our estimate includes about 1,500 persons in American Samoa, which has no AFDC program.

Increased federal costs also result from higher AFDC federal reimbursement rates, based on per capita income, instead of the fixed 75-percent rate applicable in Puerto Rico, the Virgin Islands, and Guam. Puerto Rico, the Virgin Islands, Guam, and American Samoa would receive a maximum 83-percent rate.

These cost estimates reflect offsets for collections from absent parents of AFDC children through the Child Support Enforcement Program. Thus, total AFDC costs for Puerto Rico, the Virgin Islands, and Guam, where the Child Support Enforcement Program is already fully extended, would have declined by over \$631,000. Additionally, American Samoa's estimated AFDC cost increase would have been offset by an estimated \$85,000 in child support collections.

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## Medicaid

Had Medicaid been fully extended to the areas in 1984, federal costs of providing medical assistance would have risen by an estimated \$333.1 million, or 484 percent. Areas' costs would decrease an estimated \$102 million, for a net increase of \$231.1 million. Medicaid cost estimates are particularly difficult to make because (1) numerous options are available to the areas (and states as well) under the program, and (2) Medicaid eligibility is closely linked with SSI and AFDC eligibility such that Medicaid participation rates and costs could be affected by participation rates, payment levels, and the various design options chosen for the other programs.

The higher federal costs partly result from removing areas' federal funding ceilings and replacing the 50-percent federal reimbursement rate with a higher rate. Also, in estimating the federal cost increases, we assumed that the areas' Medicaid costs would approximate those of the lowest average-cost-per-recipient state. Moreover, these costs were considerably higher than the areas' 1984 costs for their restricted programs.

The estimated numbers of participants in fully extended Medicaid programs, however, would decrease. Although the numbers of "categorically needy" persons would increase under fully extended SSI and AFDC, the numbers of "medically needy" persons would decrease due to Medicaid's more restrictive eligibility criteria. Puerto Rico and the Virgin Islands are exempt from the income eligibility limits for the "medically needy" in their areas and serve persons with much higher incomes than could be done otherwise. Imposing Medicaid's limits would make fewer "medically needy" persons eligible. Also, the numbers of the Medicaid participants in American Samoa would be less than under its existing program, which "presumes" eligibility based on the American Samoan poverty level. Guam's requirements for "medically needy" were below the limits applied in the states, so the area's participants would increase if it opted to use a higher standard (limited at 133-1/3 percent of its AFDC payment standard).

Taken together, Medicaid participants in the areas would decrease by an estimated 565,000, or about 34 percent, from the 1,641,000 participants served in 1984. Should the areas continue providing medical services to persons no longer eligible under fully extended Medicaid's stricter requirements, the areas would fund such costs without federal reimbursement—which in effect would shift some current federal costs to the areas.

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## Foster Care

Had foster care been fully extended to the areas in 1984, federal costs would have increased an estimated \$3.5 million. Area costs would increase an estimated \$1.4 million, and total costs would increase \$4.9 million. Cost increases would result partly from eliminating the funding ceiling on title IV-E foster care in Puerto Rico, the Virgin Islands, and Guam. None of the areas participated in the title IV-E foster care program in 1984. But the Virgin Islands Foster Care Program director and Guam's Social Services Administration supervisor in its Public Health and Social Services Department told us that increased title IV-E funding would have a positive effect on their programs. Some of the cost

increase would have resulted from providing title IV-B child welfare services funds to American Samoa for the first time.

Some of the children served in 1984 with area funds would have been served with federal funds under fully extended foster care. Moreover, some area officials told us they likely would elect to increase maintenance payments under fully extended foster care.

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### Child Support Enforcement

Federal Child Support Enforcement program costs would have increased an estimated \$845,000, and area costs \$341,000, for a total increase of \$1.2 million. Child Support Enforcement was fully extended in 1984 to Puerto Rico, the Virgin Islands, and Guam, so program costs there would increase as a result of increased AFDC participants, many of whom must participate in the program. Extending the program to American Samoa for the first time would increase total costs about \$96,000, which is reflected in the above estimates.

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### Food Stamps

Had Food Stamps been fully extended to the areas in 1984, federal costs would have increased an estimated \$201.1 million, or about 23 percent. Area costs would have increased \$7.1 million and total costs increased \$208.2 million. The cost increases would result mostly from reestablishing the Food Stamp Program in Puerto Rico, which would provide higher benefits to more people than under its current Nutrition Assistance Program block grant. Cost increases also would result from extending the program to American Samoa for the first time.

These cost estimates reflect offsets for increased SSI and AFDC benefits. Food Stamp costs in the Virgin Islands and Guam, where the program already is fully extended, would have declined by an estimated \$1.7 and \$3 million, respectively. Puerto Rico's and American Samoa's estimated Food Stamp cost increases would be offset an estimated \$68.3 million and \$835,000, respectively.

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### Summary of Area Views on Extending Programs

Views of area officials on the desirability and effects of extending the programs varied by area and by program.

American Samoan officials generally opposed extending most of the programs, except for SSI and their current version of Medicaid, because they believed doing so would disrupt their "extended-family"-based culture.

Nearly all officials favored extending SSI, and most officials in areas with AFDC favored eliminating the funding ceiling—which would result from fully extending AFDC. Further, most officials favored extending Medicaid, although Virgin Islands officials wished to continue the current waiver of Medicaid’s “freedom of choice” requirement, and American Samoa officials wished to retain their specially tailored Medicaid program.

Views on foster care were the most disparate. Puerto Rican officials told us they would not participate in title IV-E foster care; Virgin Islands and Guam officials said they would fully participate in titles IV-B and IV-E; and most American Samoan officials objected to all federal foster care.

Most Puerto Rico officials favored eliminating the federal funding ceiling on their Nutrition Assistance Program, which would result from reinstating the Food Stamp Program that was replaced in 1983. But they generally wished to retain the present program’s administrative flexibility, including the authority to provide benefits in cash instead of coupons. Food Stamps already is extended to the Virgin Islands and Guam. Again, most American Samoan opposed extension.

In summary, the key positive effects of extending the programs to the insular areas were seen as

- service for needy persons not covered by existing programs;
- higher benefits, enabling more recipients to meet basic living needs;
- improvements in service quantity and quality, particularly Medicaid and foster care; and
- more equitable treatment for the areas under the programs.

Key negative effects of extending the programs were seen as

- increased welfare dependency among the areas’ poor families;
- increased disincentives to work due to the higher payment levels;
- increased migration from nearby islands of the poor seeking assistance; and
- possible cultural disruptions, particularly for American Samoa.

## Area-by-Area Analysis of Effects of Extending Six Welfare Programs

Fully extending the programs would affect each area's costs and the federal costs for each area differently, as table 2.3 shows.

**Table 2.3: Costs in the Four Areas in 1984 for Welfare Programs, and Estimated Costs If Programs Were Fully Extended**

Dollars in millions				
Area	Costs <sup>a</sup>			
	Actual		Estimated, if fully extended	
	Federal	Area	Federal	Area
Puerto Rico	\$951.0	\$231.5	\$1,952.2	\$143.1
Virgin Islands	30.7	4.6	39.5	4.3
Guam	24.9	5.7	41.5	4.8
American Samoa	1.2	1.8	24.2	1.4
Subtotal	\$1,007.8	\$243.6	\$2,057.6	\$153.5
<b>Total federal and area</b>	<b>\$1,251.3</b>		<b>\$2,211.0</b>	

<sup>a</sup>Some columns do not add due to rounding.

### Puerto Rico

The greatest estimated cost change would occur in Puerto Rico--the largest of the four areas—as table 2.3 shows. Federal costs for Puerto Rico would more than double, increasing an estimated \$1 billion. Area costs would have decreased \$88.3 million, or about 38 percent. Total costs would have increased \$912.9 million. Actual and fully extended costs for the six programs in Puerto Rico are shown in table 2.4.

**Table 2.4: Costs of Welfare Programs in Puerto Rico in 1984, and Estimated Costs If Programs Were Fully Extended**

Dollars in thousands		
Program	Costs	
	Actual	Estimated, if fully extended
Adult assistance (SSI estimated)	\$21,551	\$425,861
AFDC	71,488	153,106
Medicaid	243,963	471,199
Foster care	424	4,794
Child Support Enforcement	3,462	4,144
Nutrition Assistance Program (Food Stamps estimated)	841,612	1,036,261
<b>Totals</b>	<b>\$1,182,500</b>	<b>\$2,095,369<sup>a</sup></b>

<sup>a</sup>Does not add due to rounding.

Puerto Rico's largest program cost change, were the programs fully extended there, would result from SSI replacing the area's adult assistance program (see table 2.4). In 1984, \$21.6 million was spent on Puerto Rico's adult assistance program, of which \$14.9 million was federally funded. In 1984, federal expenditures for SSI would have been an estimated \$425.9 million. Also, the number of SSI participants would have been an estimated 117,000 more than the number of 1984 adult assistance program participants, as table 2.5 shows.

**Table 2.5: Participants in Welfare Programs in Puerto Rico in 1984, and Estimated Participants If Programs Were Fully Extended**

Participants in thousands			
Program	Participants		Change
	Actual	Estimated, if fully extended	
Adult assistance (SSI estimated)	39.5	157.0	117.5
AFDC	178.9	235.9	57.0
Medicaid	1,607.0	1,045.0	-562.0
Foster care (title IV-E only)	0	2.4	2.4
Child Support Enforcement	103.6	103.6	0
Nutrition Assistance Program (Food Stamps estimated)	1,538.7	1,800.0	261.3

Note: The numbers of participants should not be totaled because a person may participate in more than one program.

The number of needy aged, blind, or disabled participants is estimated to increase because SSI benefit levels were much higher and eligibility requirements less restrictive than Puerto Rico's adult assistance program. In 1984, SSI's maximum monthly benefits were \$314 for an individual and \$472 for a couple, while Puerto Rico's maximum adult assistance benefits were \$32 for one person and \$64 for two, which was half its need standard.<sup>1</sup> As a result, Puerto Rican individuals and couples with respective annual incomes up to \$3,768 and \$5,664 could qualify for SSI. Under adult assistance, they were ineligible with respective annual incomes of \$768 and \$1,532.<sup>2</sup>

<sup>1</sup>Under the adult assistance program, the areas establish need standards (the amount of funds determined necessary for individuals to meet daily living needs) and payment standards (the maximum amount an area will pay under its program, up to 100 percent of the need standard). Puerto Rico may also pay part of the adult assistance participants' rent as a special need, but few receive such assistance, according to Puerto Rico program officials.

<sup>2</sup>When allowable income disregards were included, maximum annual incomes under both SSI and Puerto Rico's adult assistance program were higher.



Federal AFDC costs in Puerto Rico would increase by an estimated \$72.3 million, Puerto Rico's costs by \$9.3 million, and total costs by \$81.6 million.

Most of these increases would result from paying higher benefits and serving more persons qualifying under more liberal eligibility rules. Puerto Rican policy-makers told us that if AFDC were fully extended, they would double their payment standard and pay 100 percent instead of 50 percent of their need standard. In that event, payments for a mother with one child with no countable income would increase from \$32 to \$64. This and other program changes could cause the number of AFDC recipients to increase from the 1984 level of 179,000 to an estimated 236,000. Thus, new and actual 1984 participants would have received higher benefits under the fully extended program.

Some of the federal AFDC cost increase results from the higher federal reimbursement rate available under a fully extended program. Instead of the current 75-percent rate, Puerto Rico would qualify for 83-percent federal reimbursement of its total AFDC benefit payments. Eliminating the existing \$72 million federal funding ceiling on the area's combined AFDC, adult assistance, and title IV-E foster care expenditures makes the higher federal costs possible.

AFDC families with absent parents must assign support rights to the areas. Collections from absent parents are used to offset AFDC costs. We estimate a \$144.2 million offset to Puerto Rico's AFDC program costs through increased collections under the area's Child Support Enforcement Program.

Fully extending Medicaid to Puerto Rico would have increased federal costs by an estimated \$326.2 million. Puerto Rico costs would have decreased by \$98.9 million and total net costs increased by \$227.2 million.

Medicaid's more restrictive "medically needy" eligibility requirements likely would have caused a substantial decrease from actual 1984 program participation, possibly necessitating Puerto Rico's funding its own medical costs for the displaced participants. For example, the "medically needy" income limit for an individual under Medicaid would have been \$85.31 per month were Puerto Rico to increase its AFDC payment standards as envisioned at the time of our review. This limit would have been significantly below Puerto Rico's "medically needy" income limit—

\$313 per month for an individual. Consequently, many of the approximately 791,000 persons in Puerto Rico eligible for Medicaid benefits as "medically needy" would not have been eligible under the fully extended Medicaid program.

On the other hand, more persons would be made eligible for Medicaid by virtue of their eligibility for the fully extended SSI and AFDC program—the "categorically needy". (Even more would qualify as "categorically needy" and "medically needy" if Puerto Rico were to establish a higher AFDC payment standard.) The increase in "categorically needy" participants, however, would not offset the numbers of Puerto Rico's "medically needy" participants who would not be eligible under the fully extended program. Medicaid participants would decrease an estimated 562,000, from about 1.6 to about 1 million.

Other factors affecting Puerto Rico's Medicaid participation rates and costs would be (1) eliminating the \$63.4 million federal funding ceiling, (2) increasing the federal reimbursement rate from 50 to 83 percent, and (3) imposing the Medicaid "freedom of choice" requirement which, unless waived, allows Medicaid beneficiaries to choose their medical service providers. Currently, Puerto Rico Medicaid participants generally must obtain services from public health service providers. Also, Medicaid costs would be affected by which program options—from among Medicaid's numerous options—Puerto Rico (and the other areas as well) elected.

Puerto Rico received \$318,000 in title IV-B foster care funds in 1984, and, according to program officials, spent none of its title XX funds on foster care and did not participate in title IV-E foster care. Had Puerto Rico participated in title IV-E foster care in 1984, we estimate that federal costs would have increased \$3.1 million and area costs by \$1.2 million.

The Child Support Enforcement Program already is as fully extended to Puerto Rico as it is to the states. However, an increase in clientele would result from increases in the numbers of AFDC participants. Thus, we estimate that federal costs for the Child Support Enforcement Program would increase by about \$493,000 and Puerto Rico's cost by \$189,000, for a total cost increase of \$682,000.

Reestablishing Food Stamps in Puerto Rico in 1984 would have increased federal costs by an estimated \$188 million. Puerto Rico's administrative costs would increase \$6.6 million. The federal cost

increase would be considerably more than the area increase because all Food Stamp benefit costs would have been paid by the federal government.

Fully extending Food Stamps would eliminate the federal funding ceiling that exists on Puerto Rico's Nutrition Assistance Program, allowing higher benefits for more recipients. After the Nutrition Assistance Program was established in July 1982, Puerto Rico reduced benefit levels and decreased the numbers of program recipients from the June 1982 Food Stamp Program level of about 1.8 million to 1.5 million. Puerto Rico's Nutrition Assistance Program assistant director told us that, if the Food Stamp Program were reinstated, the number of participants likely would rise to approximately the June 1982 level.

As noted, cash assistance in Puerto Rico would increase significantly if SSI and AFDC were fully extended. Many recipients of Food Stamp benefits also would receive income from SSI or AFDC. Such income would be counted in determining Food Stamp benefits, thus serving to offset the amounts of Food Stamp benefits. We estimated a \$68.3 million offset for the increase in SSI and AFDC assistance.

The administrative costs associated with providing coupons under the Food Stamp Program likely would be higher than those for Puerto Rico's Nutrition Assistance Program, which provides cash benefits. A June 1985 study of the effects of replacing Puerto Rico's Food Stamp coupon program with the Nutrition Assistance Program indicated that federal and area administrative costs would be reduced nearly \$10 million if benefits were paid in cash. The report cited savings from eliminating (1) coupon production and distribution, (2) the need to monitor retail store authorizations and compliance, and (3) coupon redemptions by the Federal Reserve Bank.

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### Puerto Rican Officials' Views on Extending Programs

Most Puerto Rican policymakers with whom we spoke generally favored extending all programs except title IV-E foster care, with Medicaid receiving the most support.

Such officials as the governor, legislative members, political party (Commonwealth and Statehood) leaders, and the Department of Social Services secretary favored SSI. In his comments on our draft report, the governor stated that such assistance should be governed by a concern for providing the minimum standard of living and assistance that any U.S. citizen should have. Puerto Rico's Senate minority speaker told us

that the area's adult assistance program did not adequately provide for the special needs of aged, blind, and disabled persons. The former Puerto Rican governor told us that not having SSI in Puerto Rico drove up the costs of the area's Nutrition Assistance Program because fewer area residents would need or qualify for this program if more cash were provided under SSI. The San Juan mayor, who at the time of our review was the Statehood Party leader in Puerto Rico, told us that lack of SSI caused poor Puerto Ricans to migrate to the United States seeking assistance not available on the island. Additional funds made available through SSI and the other welfare programs, he said, would help boost Puerto Rico's economy and possibly create jobs. The Social Services Department's public assistance secretary responsible for the area's AFDC program told us that extending SSI also would allow area funds to be used for providing more services and possibly increasing AFDC benefits. The general sense among Puerto Rico officials with whom we spoke was that extending SSI would help improve recipients' standards of living and otherwise benefit the economy.

Extending AFDC also was favored. The assistant to the chairwoman of the Senate Social and Cultural Development Committee told us that the quantity and quality of AFDC services would be improved. According to the San Juan mayor, eliminating the present federal funding ceiling would increase AFDC funding and program participation and thus benefit the economy. Similarly, the Social Services Department secretary told us the federal funding ceiling forced Puerto Rico to pay inadequately low AFDC benefits. Benefit levels would increase were the funding ceiling eliminated, the Department's public assistance assistant secretary told us, and consideration could be given to expanding program coverage to include (1) certain pregnant women during the final 4 months of pregnancy and (2) 18-year-old students. Also, she said, additional funds would be used to provide needed training for AFDC caseworkers/eligibility workers.

Medicaid was the most favored program, especially among legislators. According to the Senate president, additional Medicaid funds would cause a general expansion and improvement of present medical services, including more medicines, hospital beds, and needed equipment. The Health and Welfare Committee's chairwoman told us that full Medicaid was needed to help meet needs caused in part by high unemployment and shortages of medical facilities and personnel. The House minority (Statehood Party) speaker told us limited Medicaid funding contributed to a lack of physicians and medical support staff, and prevented Puerto Rico from assisting patients who need services not now available on the

island. According to the Senate minority speaker (Statehood Party), full Medicaid was needed to enable the provision of services for all eligible persons.

The Health Department's assistant secretary for administration told us that full Medicaid would allow Puerto Rico to provide better outpatient services, emphasize preventive medicine, and expand currently available services to include psychiatric care and certain laboratory services. Also, additional funding would help provide increased services to Puerto Rico's rural areas, he said. The Department's Federal Affairs Office director said that fully extended Medicaid would allow provision of better quality medical services. The existing federal funding ceiling, he said, forced the area to spend funds providing services that under full Medicaid could be used to provide other needed services.

Views on foster care were diverse. More funding was needed for child abuse cases and group homes, several key policymakers told us. The Senate Social and Cultural Development Committee's assistant to the chairwoman said that Puerto Rico's Foster Care Program needed to provide rehabilitating services for parents who abuse children. She and the Social Services Department's assistant secretary for family services told us that additional funds could be used to provide special counseling for parental child abusers. The assistant secretary also said additional funding was needed to provide more group homes for foster children because of a shortage of family foster homes. Puerto Rico would welcome increases in titles IV-B and XX foster care funds that were less federally restrictive than title IV-E funds, she said, but title IV-B or XX funds might not be used for foster care because child abuse and child neglect currently were higher priority areas.

Both the assistant secretary and the legal counsel of the Social Services Department told us that Puerto Rico had not and likely would not participate in title IV-E foster care. Federal law requires title IV-E foster care cases to be reviewed routinely by a court or court-appointed board, they pointed out. The legal counsel also said that involving the court in voluntary foster care cases could cause a form of "cultural shock." Moreover, according to a 1985 Department of Social Services study, the Puerto Rico court took the position that it is not empowered to review matters involving the voluntary separation of children from their families that often occurred in title IV-E foster care cases. Historically, the court heard only disputed foster care cases such as when children legally were removed from a home, the legal counsel said, and voluntary cases exclusively were administered by the Social Services Department.

Further, these program officials told us that the administrative requirements for title IV-E were too costly, possibly exceeding program benefits.

As noted earlier, the Child Support Enforcement Program already is fully extended to Puerto Rico. Its director told us that caseload increases from fully extending AFDC would increase the need for Child Support Enforcement services.

Most legislators and programs officials favored removal of the funding ceiling on the Nutrition Assistance Program—which would result from extending Food Stamps—although some wished to retain certain features of the current program. If the existing federal funding ceiling were lifted, the assistant secretary's special assistant and the Nutrition Assistance Program director told us, the number of families receiving benefits also would increase. The fully extended program would improve living standards on the island, the former governor said, and afford more equitable treatment under the program for island residents. He also told us the Nutrition Assistance Program costs were high because adult assistance and AFDC benefit levels were very low. According to the San Juan mayor, the federal funding ceiling on Puerto Rico's program caused poor persons not able to receive aid to flee to the states, and more persons could be covered under fully extended Food Stamps.

The House majority speaker and the Senate president favored Puerto Rico's receiving Food Stamp benefits as a block grant that also could be used for economic development, they told us. Additional Food Stamp funds could be used to provide wage supplements for workers on public projects and private sector jobs, according to the Senate president. The House speaker cited the area's need to stimulate agricultural production to reduce its need to import food. San Juan's mayor also told us that cash rather than coupons would be preferable, because coupons were more susceptible to fraud and abuse and had higher associated administrative costs than cash payments. The Nutrition Assistance Program director favored Puerto Rico's program because administration was simpler than under the Food Stamp Program, he told us, but lifting the funding ceiling would allow more persons to be served.

Not all officials favored Food Stamps. The House floor leader told us that increased funding would provide a disincentive to work. And the Nutrition Assistance Program, as well as the Food Stamp Program, leads to long-term welfare dependency, according to a Food Stamp Program consultant on the island.



The area should be treated as a state, some Puerto Rican officials such as the former governor told us. Inequitable treatment generally resulted in migration of Puerto Ricans to the states to obtain higher benefits, according to the former governor.

Views on fully extending the programs were often divided along political lines. Many who generally favored fully extending the programs also advocated statehood for Puerto Rico. In addition, most of those supporting continued commonwealth status favored program extension, although some leaders preferred that additional funding be in the form of a block grant. Those advocating independence favored program extension, because the needs of the poor were great, but were uncomfortable with the increased dependence on the U.S. government that would accompany large programs. Our March 2, 1981, report, Puerto Rico's Political Future: A Divisive Issue With Many Dimensions, provides more information about political status deliberations in that area.

## Virgin Islands

Had the programs been fully extended to the Virgin Islands in 1984, federal costs would have increased by an estimated \$8.8 million and area costs decreased by about \$350,000. Total net costs would have increased \$8.5 million. Actual and estimated fully extended costs for each of the six programs in the Virgin Islands for 1984 are shown in table 2.6.

**Table 2.6: Costs of Welfare Programs in the Virgin Islands in 1984, and Estimated Costs If Programs Were Fully Extended**

Dollars in thousands		
Program	Costs	
	Actual	Estimated, if fully extended
Adult assistance (SSI estimated)	\$534	\$3,742
AFDC	3,516	8,526
Medicaid	4,541	5,924
Foster care	85	418
Child Support Enforcement	424	637
Food Stamps	26,215	24,550
<b>Total</b>	<b>\$35,317<sup>a</sup></b>	<b>\$43,797</b>

<sup>a</sup>Does not total due to rounding.

Under SSI, federal costs of serving the Virgin Islands' needy aged, blind, or disabled would increase an estimated \$3.4 million, and Virgin Islands' costs would decrease an estimated \$150,000. In effect, costs would shift totally to the federal government and more people would be served under SSI's higher payment levels and more liberal eligibility criteria.

Under the area's counterpart program, 1984 maximum payment levels were \$82 per month for one person and \$164 per month for two,<sup>3</sup> while SSI's maximum payments for an individual and couple respectively were \$314 and \$472 per month. The number of needy persons who would have been served under SSI's higher payment levels would have been an estimated 900 more than were served there in 1984, as shown in table 2.7.

**Table 2.7: Participants in Welfare Programs in the Virgin Islands in 1984, and Estimated Participants If Programs Were Fully Extended**

Participants in thousands			
Program	Participants		Change
	Actual	Estimated, if fully extended	
SSI/adult assistance	.4	1.3	.9
AFDC	3.9	7.7	3.8
Medicaid	14.5	13.4	-1.1
Foster care (title IV-E only)	0	<sup>a</sup>	<sup>a</sup>
Child Support Enforcement	4.6	4.6	0
Food Stamps	35.7	35.7	0

<sup>a</sup>Less than 1,000.

Note: The numbers of participants should not be totaled because a person may participate in more than one program.

Fully extending AFDC would cause the largest program cost increase. Federal costs would increase an estimated \$4.3 million while the Virgin Islands' costs would increase \$726,000. Such increases would result from eliminating the \$2.4 million federal funding ceiling on the area's combined AFDC, adult assistance, and title IV-E expenditures. Lifting the funding ceiling would allow the area's need standard to be raised, and more people would be served by higher benefit levels and more liberal eligibility criteria. Program officials said that, although they likely would continue paying only 82 percent of the needs standard, the standard would be doubled. They told us they would increase their needs standard of \$154 per month for a family with one dependent child and a caretaker to \$308. Thus, in 1984 an estimated 3,800 more persons would have participated in AFDC in the Virgin Islands, increasing the 1984 recipient count from 3,900 to 7,700.

<sup>3</sup>The Virgin Islands also covers such special-need items as nursing care.

The Virgin Islands AFDC program director did not believe the number of AFDC participants would increase appreciably under the higher eligibility/benefit levels and different eligibility criteria, she told us. Participation did not increase measurably in 1978, when the Virgin Islands last increased AFDC payment levels, she noted. But the availability of Virgin Islands' funds would, she said, govern the extent to which the AFDC program could be liberalized, and AFDC would be subject to funding restrictions the Virgin Islands' government might seek to impose. She told us the current AFDC benefits were established within such considerations.

We estimate that increased Child Support Enforcement collections from absent parents of increased AFDC-eligible families would be \$155,000, which amount was deducted from estimated costs of fully extended AFDC.

Fully extending Medicaid would increase federal costs an estimated \$2.5 million and decrease the area's costs an estimated \$1.1 million. Cost changes would result from (1) decreased numbers of "medically needy" recipients under Medicaid, (2) more "categorically needy" recipients as a result of fully extending SSI and AFDC, (3) increased federal financial participation in Medicaid, and (4) elimination of the \$2.1 million federal funding ceiling on the Virgin Islands' 1984 Medicaid Program.

A major reason Virgin Islands' costs would decrease and federal cost increases would be relatively small is the estimated drop in eligible Medicaid participants. "Categorically needy" participants resulting from higher (fully extended) SSI and AFDC eligibility standards would number an estimated 6,700 more than the 4,800 served in 1984 in the Virgin Islands. But "medically needy" participants would decrease an estimated 7,800 from the 9,600 served in 1984. While the net estimated drop of 1,100 in total participants would reduce costs, federal costs would increase due to potentially higher costs for covered medical services and higher federal financial participation in fully extended Medicaid. Also, the Virgin Islands would have qualified for the maximum 83-percent federal Medicaid sharing rate, replacing their current 50-percent rate.

In 1984, the Virgin Islands used only title IV-B and area funds for foster care, did not participate in title IV-E foster care, and used none of its available title XX funds for foster care. The area did not participate in title IV-E, the program director told us, because total federal funds for that program, AFDC, and adult assistance were capped at \$2.4 million. But the area likely would participate in the program, she said, were the

federal funding ceiling eliminated. Had the Virgin Islands participated in title IV-E foster care in 1984, federal costs would have increased an estimated \$239,000 and Virgin Islands' costs an estimated \$94,000.

The Child Support Enforcement program already is fully extended to the Virgin Islands as it is to the states. However, an increase in clientele resulting from increased AFDC participants would raise federal program costs by an estimated \$148,000 and area costs by \$64,000—or a total of \$212,000.

Food Stamps also is fully extended to the Virgin Islands, so that no changes in the program's benefit levels or eligibility criteria would have taken place. In 1984, however, federal Food Stamp costs would have been offset by an estimated \$1.7 million due to increases in the countable incomes of beneficiaries also participating in fully extended AFDC and SSI.

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### Virgin Islands' Officials' Views on Extending Programs

Virgin Islands' officials with whom we spoke generally favored extending the programs. Program officials, including the area's income maintenance director, told us that the higher SSI and AFDC benefits would enable recipients to better meet their needs and that current benefits levels were inadequate to satisfy daily living requirements. The current adult assistance and AFDC need standard for one person, the official said, was less than the average rent cost in the Virgin Islands' low-cost areas. A consumer interest group representative told us that some adult assistance and AFDC participants lived in substandard housing because they could not afford higher rent payments with the low benefits they received. Also, extending SSI would enable disabled children under 18, who were not eligible under the area's adult assistance program, to receive assistance, program officials told us.

According to the chairman of the Virgin Islands Senate Health and Human Resources Committee, additional foster care funds made available by eliminating the existing federal funding ceiling would help more children in need of such assistance. The additional funds could be used to recruit more foster care parents, the director of the Social Service Department told us. Some area children had to live in institutions at high cost to the area government, the director said, because there were not enough foster care homes to meet area needs. The executive director of foster care told us that, because available foster care funds were so limited, many foster homes were not much better than the undesirable homes the children left.

The chairperson of the St. Croix Foster Care Review Team, which oversees foster care cases the Social Welfare Department administers, told us that limited funding and related staffing shortages were major barriers to their providing adequate foster care. In a May 12, 1986, letter to GAO, she pointed out that, although foster care in the Virgin Islands was intended to be a temporary service, according to 1985 case reviews the average length of care provided was over 7 years. Available staff for administering foster care was insufficient, she told us, to adequately screen and support foster families, prepare social summaries for the courts to clarify custody matters, counsel with children, work with natural families so children could return home, seek adoptive families for waiting children, or handle much more than emergencies.

Additional Medicaid funds made available by eliminating the funding ceiling would improve residents' well-being by allowing the area to provide better medical services, according to the Insurance and Medical Assistance Bureau director. She told us that providing certain specialized services under fully extended Medicaid would reduce area residents' need to migrate to the U.S. to obtain proper care. Also, certain medical services not provided would be provided under Medicaid, she told us.

General area views about extending welfare programs were reflected in a 1975 Virgin Islands Social Welfare Department report entitled, Federal Financial Discrimination in the Public Assistance Programs of the U.S. Virgin Islands. The report stated:

"The basic fact is that compared with welfare programs in the U.S., the Virgin Islands does not receive an equitable share of Federal support. The results are a discredit to all involved. Virgin Islands residents are deprived of the level of benefit services that they have a right to expect as U.S. citizens."

Some officials including the Social Services Department's executive director and public interest group representatives told us that fully extending AFDC and Food Stamp benefits might increase welfare dependency in the area by creating disincentives to work. Increased welfare would stifle the ambitions of the area's youth, a prominent Virgin Islands businesswoman, active in national politics, said, and the area would be better served through assistance aimed at developing the economy. In addition, it was unreasonable to expect the area with its limited federal funds to meet the same program administrative requirements for compliance with federal regulations as states, the income maintenance director told us.

The Social Welfare Department executive director expressed concerns that higher welfare benefits could cause increased migration from other islands, such as St. Kitts. He told us he received frequent inquiries from foreign neighbors concerning their possible eligibility for current Virgin Islands' benefit programs and speculated that such interests would be even greater if benefits were expanded.

## Guam

Had the programs been fully extended to Guam in 1984, federal program costs would have increased an estimated \$16.6 million, while Guam's costs would have decreased an estimated \$922,000. Total net costs would have increased about \$15.7 million. Actual and fully extended costs for the six programs in Guam are shown in table 2.8.

**Table 2.8: Costs of Welfare Programs in Guam in 1984, and Estimated Costs If Programs Were Fully Extended**

Dollars in thousands

Program	Costs <sup>a</sup>	
	Actual	Estimated, if fully extended
Adult assistance (SSI estimated)	\$1,110	\$8,377
AFDC	5,211	13,131
Medicaid	4,187	7,521
Foster care	0	82
Child Support Enforcement	313	411
Food Stamps	19,736	16,728
<b>Total</b>	<b>\$30,558<sup>a</sup></b>	<b>\$46,249<sup>a</sup></b>

<sup>a</sup>Does not total due to rounding.

Under SSI, federal costs would increase an estimated \$7.8 million, while Guam's costs for its eliminated adult assistance program would decrease \$496,000. Most of the SSI cost increase results from higher benefits and more participants. An estimated 1,500 more persons than were served in Guam in 1984 would have been served under SSI, as table 2.9 shows. Guam's maximum monthly adult assistance benefit levels of \$60 for one person and \$120 for two<sup>4</sup> would have been replaced with SSI's levels of \$314 for one person and \$472 for couples.

<sup>4</sup>In addition to cash assistance for basic needs, Guam provided up to \$75 per month for special needs. According to a 1984 study of the potential cost of increasing Guam's need standard, however, most people did not receive assistance for special needs.



**Table 2.9: Participants in Welfare Programs in Guam in 1984, and Estimated Participants If Programs Were Fully Extended**

Participants in thousands			
Program	Actual	Participants	
		Estimated, if fully extended	Change
SSI/adult assistance	1.0	2.5	1.5
AFDC	6.8	9.4	2.6
Medicaid	8.2	14.0	5.9 <sup>a</sup>
Foster care (title IV-E only)	0	<sup>b</sup>	<sup>b</sup>
Child Support Enforcement	2.7	2.7	0
Food Stamps	22.2	22.2	0

<sup>a</sup>Some figures do not add due to rounding.

<sup>b</sup>Less than 1,000.

Note. The numbers of participants should not be totaled because a person may participate in more than one program.

Federal AFDC costs also would increase significantly—from \$2.9 to \$10.7 million, or about \$7.8 million. Guam's AFDC costs would rise an estimated \$158,000, for a total increase of \$7.9 million. The high federal costs would result partly from (1) increasing federal benefit reimbursement rates from Guam's existing 75-percent rate to 83 percent and (2) greater program participants due to fully extended AFDC's higher benefit levels and more liberal eligibility criteria. Guam officials told us they would continue to pay 100 percent of the need standard but likely would increase the standard from \$120 per month for a family with a caretaker and one dependent child to \$258. Thus, we estimated that AFDC participants would have been about 2,600 more than the 6,800 served there in 1984, or 9,400 persons.

We estimate that increased Child Support Enforcement collections from the absent parents of increased AFDC-eligible families would be \$113,000, which was deducted from fully extended AFDC's estimated costs.

Federal Medicaid costs in Guam would have increased an estimated \$4.0 million and Guam costs decreased an estimated \$639,000. The net total increase would have been \$3.3 million. Federal costs would increase due to potentially higher costs for covered medical services and higher federal financial participation in Medicaid, and because an estimated 5,900 more persons than were served in 1984 under the area's program would have been served under fully extended Medicaid. Like the other areas, the estimated numbers of "categorically needy" Medicaid participants would increase as a result of fully extending SSI and AFDC. But unlike the other areas, the number of "medically needy" participants also would

increase. We estimate that in 1984, 5,400 new "categorically needy" persons and 450 more "medically needy" persons—in addition to the 7,527 "categorically needy" and 649 "medically needy" persons served—would have been served under Medicaid.

Guam's "medically needy" numbers would have increased because Medicaid's "medically needy" eligibility criteria is higher than Guam's 1984 criteria. That year, Guam served a small number of such persons and in 1985 discontinued serving the "medically needy" due to funding limitations. Public Health and Social Services Department officials told us that, were Medicaid fully extended, thus eliminating the federal funding ceiling on their Medicaid program, they likely would reinstate the program's "medically needy" component.

In 1984, Guam consolidated funds from its title IV-B Child Welfare Services Program, title XX Social Services Block Grant, and several other programs<sup>6</sup> to provide a variety of services, including foster care. Guam received about \$826,000 in federal funds under its consolidated grant in 1984, but neither we nor Guam officials—because Guam is not required to report to the federal government on how its consolidated funds were used—could readily determine the amounts spent for foster care. The Public Health and Social Services Department's Social Services Administration supervisor told us that one counselor handling foster care was paid with such funds.

The Social Services Administration supervisor told us Guam had not participated in title IV-E foster care due to funding limitations imposed by the \$3.3 million federal funding ceiling on Guam's AFDC, adult assistance, and title IV-E expenditures. The area placed a higher priority on adult assistance and AFDC services and spent its entire funding allotment on such services, she said, and thus had not applied for title IV-E foster care funds. But the area would participate in the program if fully extended, with the funding ceiling removed, she told us. Had the program been fully extended to Guam in 1984, we estimate that federal foster care costs would have been \$58,000 higher and the area's costs about \$24,000 higher.

The Child Support Enforcement Program already is fully extended to Guam. However, an increase in clientele resulting from increased AFDC

<sup>6</sup>Under the authority of title V of Public Law 95-134, federal agencies may consolidate certain grants to the Virgin Islands, Guam, American Samoa, and other areas to minimize their burden in applying for and reporting on federal grant assistance.

participants would raise federal program costs by an estimated \$69,000, and area costs by an estimated \$29,000—or a total of \$98,000.

Food Stamps are also fully extended to Guam. Federal Food Stamp Program costs would have been offset, however, by an estimated \$3 million due to increases in the countable incomes of beneficiaries also participating in fully extended AFDC and SSI.

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### Guam Officials' Views on Extending Programs

Guam's governor, legislators, and program officials with whom we spoke generally favored extending most of the six programs, mentioning many of the positive effects cited by Puerto Rican and Virgin Islands officials. The potentially higher numbers of needy persons served and higher benefits, Guam officials told us, would improve the living standards and general well-being of needy residents not adequately served under existing programs. They told us that area funds freed through increased federal funding could be used to improve program administration and provide such needed services as education, employment, and better medical services. The latter could include psychiatric care and services not now available on the island. Also, higher medical reimbursement rates could be paid to the area's private service providers, some of which were receiving substandard reimbursement rates, officials told us.

In 1985, Guam's legislature passed a resolution requesting the U.S. Congress to amend the Social Security Act to extend SSI to Guam. The resolution stated:

"... the residents of the Commonwealth of the Northern Marianas are now receiving the full benefits of the Supplemental Security Income program as a result of their present political status; and ... the people of Guam firmly believe in the right to equal treatment of any resident or citizen of the United States to the benefits available to them from the United States Federal Government without regard to ... geographical remoteness or boundaries."

More recently, Guam officials have sought a modified Food Stamp Program that would require some funds to be spent on local produce—a program similar to that in the Northern Mariana Islands.

According to the Child Support Enforcement Program coordinator, the area's program allowed some families to stay off welfare and forced absent fathers to face up to their child support obligations. The Food Stamp Program had improved the availability and quality of food on the

island, the social services administrator told us, and allowed some young couples and elderly persons who desired to do so to live relatively independently of their families. Officials said that the additional federal funds would help ease the financial burden on other families caring for their elderly.

The Social Services Department administrator, however, told us that increased welfare benefits in Guam might result in increased welfare dependency and reduced incentives to work. According to the governor's federal programs special assistant, the current Food Stamp Program work requirement was not strict enough, and fully extended SSI and AFDC would place an increased financial burden on Guam's government to make higher Medicaid expenditures for a larger number of Medicaid recipients.

With limited federal funds, the Public Health Department's health services administrator said, it was unreasonable for the area to be expected to meet the same fully extended program administrative requirements, including fraud prevention and quality control procedures, that states must meet.

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## American Samoa

Fully extending the six programs to American Samoa—the smallest of the four areas—would have significant cost and, in the opinion of most area officials, adverse social effects on the area. Were all six programs extended to American Samoa, five would have been available there for the first time. Except for SSI and the modified Medicaid program that exists there, however, most American Samoan officials strongly opposed extending the programs.

Had the programs been fully extended in 1984, federal costs would have increased an estimated \$23.1 million and American Samoa's costs decreased \$460,000—for a total net increase of \$22.6 million. Actual and fully extended costs for the six programs in American Samoa are shown in table 2.10.

**Table 2.10: Costs of Welfare Programs in American Samoa in 1984, and Estimated Costs If Programs Were Fully Extended**

Dollars in thousands		
Program	Costs	
	Actual	Estimated, if fully extended
Adult assistance (SSI estimated)	\$0	\$3,362
AFDC	0	1,729
Medicaid	2,969	2,085
Foster care	0	120
Child Support Enforcement	0	96
Food Stamps	0	18,214
<b>Totals</b>	<b>\$2,969</b>	<b>\$25,606</b>

Federal SSI costs would have increased an estimated \$3.4 million, and American Samoan costs would not be affected by the total federal funding of the programs. Also, SS. would have served an estimated 1,000 needy aged, blind, or disabled American Samoans, as shown in table 2.11.

**Table 2.11: Participants in Welfare Programs in American Samoa in 1984, and Estimated Participants If Programs Were Fully Extended**

Participants in thousands			
Program	Participants		
	Actual	Estimated, if fully extended	Change
SSI/adult assistance	0	1.0	1.0
AFDC	0	1.5	1.5
Medicaid	11.3	3.2	-8.1
Foster care (title IV-E only)	0	<sup>a</sup>	<sup>a</sup>
Child Support Enforcement	0	0.1	0.1
Food Stamps	0	21.1	21.1

<sup>a</sup>Less than 1,000.

Federal AFDC costs would increase an estimated \$1.4 million and area costs about \$323,000. AFDC would serve an estimated 1,500 dependent children and their caretakers for the first time. The benefit amounts used in making our AFDC estimate reflect the income levels needed to satisfy daily living needs as reflected in a 1982 American Samoan government study, *Household Survey of Expenditures*. In addition, we estimate that increased child support collections from the absent parents of increased AFDC-eligible families would be \$85,000, which was deducted from fully extended AFDC's estimated costs.

Federal Medicaid costs would increase an estimated \$520,000. American Samoa's Medicaid costs, however, would decrease about \$1.4 million. Thus, total costs would decrease an estimated \$884,000.

Lower Medicaid costs would result from conforming American Samoa's Medicaid program to the fully extended version. The area's Medicaid costs would be directly affected by the area's decisions on AFDC. Medicaid costs would be higher than estimated if American Samoa opted for a higher payment standard. If it opted for lower AFDC benefits or did not implement AFDC, Medicaid costs would be lower. The area's program was established in 1982 under special federal legislation authorizing the HHS secretary to waive or modify most Medicaid requirements to meet the area's special needs. Also, federal reimbursement for the area's program is based on "presumed eligibility." That is, the federal government reimburses American Samoa a percentage of its total medical costs presumed to have been incurred for needy individuals. The percentage takes into account the numbers of individuals in the area with incomes below the American Samoa poverty level—which is substantially below the U.S. poverty level. For 1984, the American Samoa government estimated approximately 11,000 persons were below the area's poverty level. We estimate that in 1984 only 3,200 persons would have been eligible for fully extended Medicaid.

Had titles IV-B and XX as well as title IV-E foster care been fully extended to American Samoa in 1984, federal costs would have increased an estimated \$88,000, and area costs an estimated \$32,000. Total costs would increase \$120,000. Also comparatively small would be the cost of extending Child Support Enforcement. Federal costs would increase almost \$68,000 and area costs \$29,000, for a total cost increase of \$96,000.

Extending Food Stamps would cause the largest cost change. Federal costs would have increased an estimated \$17.7 million, and area costs an estimated \$560,000. Also, an estimated 21,000 persons (about 60 percent of the area's 35,000 residents) would be eligible for Food Stamps because the average American Samoan family income was so low. In 1984, American Samoa's per capita income was \$3,270 compared to the U.S. per capita income of \$12,789. Our estimate of potential Food Stamps costs included an offset of about \$836,000, accounting for increases in countable income from fully extended AFDC and SSI for participants who would also receive Food Stamps.



## American Samoan Officials' Views on Extending Programs

American Samoan officials, including the governor, lieutenant governor, and most legislature members, opposed extending most of the six programs to their area. Their primary concerns centered on the possible adverse effects of the programs on their culture which, they told us, was why there are no welfare programs except Medicaid there.

The American Samoan culture is rooted in the "extended family," whereby generations of families live and work together in communal support to meet their family living needs. The governor and many other officials told us that federal programs might shift to the government such responsibilities as care for the young, elderly, and disabled that historically have been met by extended families. Other subsistence needs were met, the governor said, by such programs as the Administration on Aging's "food voucher" program, which provided food to low-income elderly persons, and the federally funded school lunch program for young children.

Welfare had a negative connotation in the area, these officials told us, and individuals choosing to participate would be criticized within their communities—possibly resulting in limited program participation. According to members of the attorney general's office, in their society a family receiving welfare would be viewed as not able to provide properly for its own members, which would be disgraceful. One Health Department official told us that families using foster care would be viewed as unable to raise their children, as well as having publicly made the family's problems known.

But members of the Office of Samoan Affairs, as well as a district governor, favored extending SSI. The area culture had changed in some ways over the years, they pointed out, to the extent that the aged and disabled were not always properly cared for by their extended families, and SSI should help reduce financial burdens on families caring for their needy and infirm members. Some officials, including the governor, did not favor extending SSI for fear of destroying the area culture.

Medicaid is viewed differently in American Samoa than are other welfare programs. A government official told us that medical care always has been provided by the U.S. government, beginning with the U.S. Navy's administration of the islands. Also, welfare's stigma is not attached to Medicaid because, under their modified Medicaid program, American Samoans need not meet low-income eligibility requirements to receive services.

Child abuse and neglect, the Samoan Affairs secretary told us, were problems the government could not adequately address because of inadequate foster care funds. There was need for more foster care, Health Department officials said, and for higher payments for homes to provide foster care under the area's program. Also, they said, a group home was needed for foster children, as well as more professionals and counselors for the children.

A few officials objected to the programs as potentially too costly. AFDC and Food Stamps would be too expensive, the governor's chief of staff told us. The Health Planning Agency director told us that a fully extended Medicaid program would be costly because of the extensive administrative costs and requirements.

Finally, the governor and the House speaker told us that extending the programs likely would increase migration to the area. Half the American Samoan residents now are from Western Samoa, they said, and more immigrants likely would come.

# Effects of Extending Federal Income Taxes: Revenues and Area Views

Fully extending federal corporate and personal income taxes to the four insular areas would increase federal and decrease areas' revenues. Assuming the areas' business activity and economic conditions remained unchanged and the areas' income taxes were replaced by the federal taxes, federal revenue would have increased an estimated \$2.7 billion for tax year 1983 (see table 3.1). But we believe that over the medium and long term, annual federal revenue increases could be far smaller, possibly declining to \$2.1 billion or less, after some businesses operating in the areas reacted to the tax extension by closing, relocating, or downsizing operations. Correspondingly, the areas would have lost all income tax-generated revenue—an estimated \$1.416 billion (see table 3.2).

**Table 3.1: Estimated Federal Revenue Increases Under Fully Extended Federal Income Taxes (Tax Year 1983)**

Dollars in millions

Income tax	Revenue increases, estimated				Total
	Puerto Rico	Virgin Islands	Guam	American Samoa	
Individual	\$365.2	\$84.6	\$77.7	\$3.7	\$531.2
Corporate	2,080.0	36.9	13.2	10.6	2,140.7
<b>Total increase</b>	<b>\$2,445.2</b>	<b>\$121.5</b>	<b>\$90.9</b>	<b>\$14.3</b>	<b>\$2,671.9</b>

## Effects on Revenues

U.S. income tax revenue would have increased by fully taxing U.S. corporations, area businesses, and residents benefiting from special income tax treatment applicable to the areas. The increase would stem from (1) eliminating the 936 tax credit available to qualifying U.S. corporations, (2) eliminating the foreign tax credit available to certain U.S. corporations that pay taxes to the area governments, (3) taxing U.S. corporations exempt from federal income taxes as Virgin Island inhabitants, (4) taxing area-chartered corporations exempt from federal tax on area-source income, and (5) taxing area residents' income that is partly or totally exempt from federal income tax. The estimates in table 3.1 assume no changes in the areas' 1983 tax base.

About \$2.1 billion of the potential \$2.7 billion increase in federal revenue in 1983 would have come from increased corporate income taxes, as table 3.1 shows. This would have resulted primarily from fully taxing—through eliminating the 936 tax credit—U.S. corporations operating in the areas. For tax year 1983, 631 U.S. corporations qualified for and 552

claimed over \$1.966 billion in tax credits under this section. Not all federal tax expenditures<sup>1</sup> associated with this credit likely would have converted to federal revenue, however, because corporations could have taken advantage of certain other income tax provisions not available to them when they claimed this tax credit. For example, corporations claiming the 936 tax credit in 1983 generally were not entitled to use the accelerated cost recovery system of depreciation. Allowing for such adjustments, we estimated that about \$1.9 billion would have flowed to the U.S. Treasury from those U.S. corporations in 1983.

Over \$531 million of the potential increases in federal revenue would have come from personal income taxes. The estimated increase would have stemmed mostly from taxing Puerto Rico, Guam, and American Samoa residents' area-source income, which generally has been exempt from federal income taxes, and Virgin Islands inhabitants' worldwide income, which until 1987 was exempt from federal taxes.

### Area Income Tax Revenues Would Decline: Officials Would Oppose

Fully extended federal income taxes would have reduced area governments' revenue had federal income taxes replaced the areas' income taxes. Individual and corporate income taxes, important in financing area government operations, comprised from 31 to 41 percent of operating revenues in 1984. As table 3.2 shows, the areas would have lost an estimated \$1.4 billion of tax revenues had federal income taxes replaced area income taxes in 1983; about 85 percent of the loss would have been borne by Puerto Rico.

**Table 3.2: Area Income Tax Revenues**  
(Tax Year 1983)

Dollars in millions					
Income tax	Revenue, estimated				
	Puerto Rico	Virgin Islands	Guam <sup>a</sup>	American Samoa	Total
Individual	\$725.1	\$84.6	\$77.7	\$4.4	\$891.8
Corporate	477.2	28.5	9.9	8.9	524.4
Total income	\$1,202.3	\$113.1	\$87.6	\$13.2 <sup>a</sup>	\$1,416.2

<sup>a</sup>Does not add due to rounding.

As shown, the areas collected an estimated \$524 million in corporate income tax revenue for tax year 1983. However, the areas exempted or rebated another \$2.35 billion of area income taxes to certain corporations through incentive programs aimed at stimulating economic growth.

<sup>1</sup>Tax expenditures are special tax reductions and the associated amount of revenue foregone.

Such exemptions and rebates, which the U.S. Code does not allow, account for much of the difference between estimated area corporate income tax collections and estimated federal corporate revenue increase for tax year 1983.

Almost 65 percent of the areas' income tax revenues, except for American Samoa, was generated from personal income taxes, which totaled an estimated \$892 million for tax year 1983 (see table 3.2). Personal income tax collections and our estimates of federal personal tax revenue under fully extended federal income taxes were identical for the Virgin Islands and Guam. Puerto Rico and American Samoa personal tax collections, however, were higher than estimated federal income tax revenue. This is because the areas' income tax systems were less generous than the federal personal income tax system. For example, in 1983 neither area allowed the earned income tax credit<sup>2</sup> allowed by the United States for individuals with dependent children and adjusted gross incomes under \$10,000.

## Summary of Area Views on Extending Federal Income Taxes

In general, area officials strongly opposed extending U.S. income taxes. The exceptions were leaders of the Puerto Rican Statehood Party, who favored a gradually phased-in U.S. income tax accompanied by statehood. Most often, officials expressed concerns about

- adverse economic consequences of eliminating corporate tax incentives,
- prospects and unknown consequences of changing their present fiscal autonomy, and
- fiscal difficulties they would face trying to compensate for revenue shortfalls.

In addition, some Puerto Rico officials questioned whether the United States can alter unilaterally the U.S./Puerto Rico tax relationship. The relationship is based on section 9 of the Puerto Rico Federal Relations Act (Public Law No. 81-600), which is part of the U.S./Puerto Rico Compact that provided for Puerto Rico's constitutional form of government. Some interpret the Compact as preventing the Congress—without Puerto Rico's consent—from substantively changing the Puerto Rico Federal Relations Act, including changing the area's tax status. Others believe that, despite the Compact, Puerto Rico still is a U.S. territory

<sup>2</sup>In 1988, the earned income tax credit will be available for individuals with up to \$17,000 of adjusted gross income. Phase-out levels and maximum credit amounts are to be adjusted annually for inflation.

subject to the Congress' plenary authority, including authority to unilaterally alter its tax status. This controversial issue has not been resolved by the courts.

## Area Business Reaction Could Reduce Federal Tax Revenue

Over the medium and long term, federal tax revenues could be reduced to \$2.1 billion or less—to the extent businesses in the areas currently utilizing the tax preferences reacted to the loss of these preferences by relocating to foreign countries or down-sizing their U.S. operations. Such changes also would adversely affect corporate tax revenues from other businesses, particularly those that are suppliers to or otherwise depend heavily on the U.S. firms operating in the insular areas. Personal income tax revenues also would decrease to the extent such business contractions would lead to a reduction in jobs in the United States.

It is impossible to predict precisely how business would react or how long those reactions would be delayed. Nonetheless, some idea of the possible impacts of corporate responses on Treasury receipts and the Puerto Rican economy can be derived from an analysis of the industrial composition of corporations claiming the section 936 credit. To the extent that firms in a given industry are likely to remain in Puerto Rico or return to the mainland, total Treasury receipts and total U.S. employment might not be adversely affected. To the extent the firms in an industry are likely to relocate overseas, Treasury receipts and U.S. employment would be reduced. However, if firms left Puerto Rico, whether to relocate in the mainland or overseas, the island's economy would contract, reducing output and employment in its manufacturing sector, as well as other parts of its economy.

As noted earlier, of the \$2.7 billion in potential tax revenues that would have flowed to the U.S. Treasury in 1983, about \$1.9 billion would have come from U.S. corporations in Puerto Rico, most engaged in manufacturing. In the aggregate, these corporations employed about 81,000 workers, accounting for 11 percent of Puerto Rican employment.

Pharmaceutical and food processing firms accounted for about \$1 billion of the section 936 credit claimed in 1983 and employed about 18,000 workers in Puerto Rico. As discussed in appendix IV, firms in these two industries would be unlikely to leave the United States, although they might leave Puerto Rico. Treasury receipts from these industries, therefore, probably would not be reduced. The Puerto Rican economy, however, could suffer if corporations moved back to the mainland.



It is more likely that some electric and electronic firms would relocate to neighboring Caribbean nations, while others might stay in Puerto Rico or return to the United States mainland. These firms accounted for \$422 million of the section 936 credit claimed in 1983 and employed about 26,000 workers in Puerto Rico. If, for example, one-third of these relocated outside of the United States, the estimate of 1983 Treasury corporate profit tax receipts would be reduced by about \$141 million, and the Treasury would lose the personal income taxes from about 8,700 workers displaced from these firms. Treasury receipts in corporate and personal income taxes from other related local businesses also would be reduced accordingly.

If another one-third of these firms left for the U.S. mainland, Puerto Rico would lose an additional 8,700 manufacturing jobs and another one-third of its electronic industry output. It also would suffer reductions in output and employment in other related businesses.

The probability of leaving the United States entirely is probably highest for firms in the apparel, hospital supply, scientific instrument, and other manufacturing industries. Together, these firms accounted for \$462 million of the section 936 credit claimed in 1983 and employed about 37,000 workers. If all of them relocated outside the United States, the estimate of 1983 Treasury corporate tax revenues would fall by about \$462 million, and additional losses of the personal income taxes otherwise paid by some 37,000 displaced workers would occur. In addition, the Treasury could lose corporate and personal income taxes from related businesses. Losses in output and employment would be borne largely by the Puerto Rican economy.

Medium- and long-term adjustments of the type hypothesized here would reduce our estimate of Treasury corporate profit taxes by at least \$603 million. Additional revenue losses would occur to the extent that the displacement of about 45,700 manufacturing jobs reduced personal income tax collection. Further losses would occur to the extent the adjustment reduced other business activities and employment. The adverse impact on the Puerto Rican economy could be larger to the extent that manufacturing jobs, corresponding output, and related business activities and employment moved from the island to the mainland.

Similarly, the Virgin Islands, Guam, and American Samoan economies could be affected by full tax extension. To the extent that businesses relocated to foreign countries, closed, or downsized, federal tax revenues in these areas would be reduced below our 1983 projections.

Local tax incentives in the Virgin Islands were considered critical to attracting new businesses and retaining existing firms. Some officials told us that many firms came to the Virgin Islands primarily to avail themselves of the tax advantage such incentives provide. To the extent corporations claiming Virgin Islands incentives are not engaged in tourism or other business dependent on location, some might relocate should incentives be removed.

Section 936 credits were not considered critical to Guam's economy, possibly because few firms took advantage of the provision—only \$1.6 million in credits were claimed in 1983. Local rebates, however, were considered very important. Much of Guam's local economy was dependent on the U.S. military presence and the tourist trade, especially from Japan. Guam business officials told us that elimination of local rebates could stymie business expansion, but did not forecast a large-scale effect on existing firms. Moreover, the large military presence would tend to stabilize personal tax revenues, because military pay is not dependent on the island's economy, and Guam receives the proceeds of income taxes paid by U.S. military personnel stationed there. The extent to which military personnel obtain goods and services from Guam suppliers also may tend to stabilize the overall economy. However, according to the Speaker of Guam's legislature, the military meets much of its needs on base, without adding to the local economy.

The combination of section 936 credits and local tax incentives were considered critical to American Samoa's economy. Officials were concerned that the tuna canneries operating there would relocate if U.S. taxes were fully extended. The tuna canneries, we were told, contributed the largest portion of the area's revenues and had a major effect on other businesses, such that the economy would be seriously harmed should the canneries leave.

Also, federal revenue increases could be reduced to the extent area governments imposed income or other taxes deductible from federal tax liability. Puerto Rico officials told us that area income taxes likely would be continued, although at reduced rates. Virgin Islands officials said an area income tax likely would be imposed, but did not speculate about its design. Such area income taxes—although area officials did not specify potential rates—could increase estimated area revenues and lessen estimated revenues from federal income taxes, because such taxes could qualify as allowable personal itemizations or business deductions.

## Area-by-Area Analysis of Effects of Extending Federal Income Taxes

Revenue and other effects of fully extending federal income taxes would vary by area, as discussed below.

### Puerto Rico

Had federal income taxes been fully extended to Puerto Rico in 1983, federal revenue would have increased by an estimated \$2.4 billion. About \$2.1 billion would result from taxing corporations and \$365 million from taxing individuals.

### Corporate Tax Revenue

About \$2.1 billion of the increase would have stemmed from fully taxing corporations, primarily from eliminating the section 936 tax credit, as discussed above.

Some of the estimated federal revenue would result from eliminating the foreign tax credit taken by U.S. corporations for taxes paid to Puerto Rico. According to an Internal Revenue Service official, the amount of foreign tax credit received for tax year 1983 was not readily available. U.S. corporations claimed about \$79 million of credit for tax year 1982 for taxes paid to Puerto Rico.

Some of the revenue would have resulted from fully taxing corporations chartered in Puerto Rico, including taxing area-source income, which generally is exempt from federal income taxes. Potential revenues for 1983 from fully taxing such companies could not be reliably estimated from detailed tax data; at the time of our field work, the latest full-year corporate taxable income data available from the Puerto Rico Treasury Department was for tax year 1981. Instead, we estimated potential taxes from corporations that claimed section 936 credits and added Puerto Rico taxes collected from other companies (Puerto Rico and U.S. tax rates were about the same in 1983).

Puerto Rico would have lost a substantial portion of its operating revenue had its corporate income tax been replaced by the federal income tax. For tax year 1983, Puerto Rico collected about \$1,202 billion in income taxes, representing about 32 percent of the area's 1984 operating budget. Approximately 40 percent of the area's income tax revenue came from its corporate income tax and 60 percent from personal taxes.

We estimate that 1983 federal corporate income tax revenue would be about \$1.603 billion higher than the \$477 million actually collected by Puerto Rico. This is primarily because the federal income tax system does not allow exemptions authorized under Puerto Rico's tax system for certain corporations. More specifically, Puerto Rico exempts from income tax up to 90 percent of the income of corporations meeting such criteria as producing certain articles on a commercial scale. This benefit is one of several offered under the area's Industrial Incentives Act of 1978, designed to stimulate economic development and investment in Puerto Rico. According to the Puerto Rico Treasury Department, \$2.34 billion in area income taxes was exempted during calendar year 1983.<sup>3</sup>

The differences between Puerto Rico's actual 1983 collections and our estimate of probable federal corporate tax revenue also are due to other differences in the Puerto Rican and U.S. income tax systems. In addition to tax exemptions and depreciation, there were some differences in corporate tax rates in 1983. Puerto Rico's rates ranged from 22 to 45 percent, and U.S. rates ranged from 15 to 46 percent.

## Personal Tax Revenue

About \$365 million of the federal revenue increase in Puerto Rico would come from taxing individuals whose area-source income was exempt from federal taxation. This estimated increase was about \$360 million less than the \$725 million Puerto Rico collected in personal income taxes for tax year 1983. The difference between estimated and actual area collections primarily was due to differences in the Puerto Rican and U.S. income tax systems.

Many Puerto Rican personal income tax provisions, including allowances for personal exemptions and deductions, were less generous than the federal income tax provisions. Additionally, Puerto Ricans' personal rates were higher than the federal rates in 1983. Consequently, some Puerto Rican taxpayers could have paid higher income taxes than U.S. taxpayers with the same income, exemptions, deductions, and credits, as illustrated in table 3.3.

<sup>3</sup>Under Puerto Rico's predecessor industrial incentives program, corporations could receive income tax exemptions as high as 100 percent. Some corporations continue to receive such benefits.

**Table 3.3: Comparison of U.S. and Puerto Rican Income Taxes for a Hypothetical Family**

	Tax calculation for married couple <sup>a</sup> with two children	
	Puerto Rico	U.S.
Adjusted gross income	\$18,000	\$18,000
Deduction:		
Standard	2,000	<sup>b</sup>
Auto license plates	25	0
Interest	975	0
Total deductions	3,000	0
Exemptions	3,800	4,000
Net taxable income	11,200	14,000
<b>Total tax liability</b>	<b>1,916</b>	<b>1,510</b>

<sup>a</sup>Filing jointly and claiming a standard deduction.

<sup>b</sup>Already incorporated in U.S. tax rates, the zero bracket allowance for this example would have been \$3,400.

The hypothetical Puerto Rican taxpayers have a higher income tax liability than the U.S. taxpayers because their deductions and exemptions are smaller than those allowed under the U.S. income tax system, and Puerto Rico's tax rate is higher than the U.S. rate. For example, in 1983 the U.S. taxpayers would have been allowed \$4,000 for exemptions (\$1,000 for each), but the Puerto Rican taxpayer was entitled to \$3,800 (\$1,000 per adult, \$800 for one child, and \$1,000 per child in college). Also, the U.S. zero-bracket amount of \$3,400—already incorporated in the U.S. tax tables—exceeded the \$3,000 of total deductions allowed the Puerto Rican taxpayers. Further, the Puerto Rican taxpayers in this example paid a higher marginal rate<sup>4</sup> on taxable income. In 1983, Puerto Rico's marginal tax rate for a married couple filing jointly with taxable income between \$10,000 and \$12,000 was 25.65 percent, while the U.S. rate for taxable income between \$11,900 and \$16,000 was 17 percent (15 percent after 1988). In addition, Puerto Rico's maximum marginal rate was 67.55 percent during 1983 for incomes over \$200,000, compared with the U.S. maximum rate in 1983 of 50 percent for incomes over \$54,700, depending on filing status (28 percent in the United States after 1988).

Tax law changes since 1983 still leave U.S. taxpayers in a more favorable position than their Puerto Rican counterparts. Puerto Rico's maximum personal rate was reduced to 50 percent effective January 1,

<sup>4</sup>Marginal tax rate refers to the percentage to be applied in calculating tax liability on income above the lower limit of the applicable tax bracket.

1986, but this change would not affect the tax liability of the hypothetical taxpayers. In contrast, the Tax Reform Act of 1986 would have further reduced the U.S. taxpayers' liability. For 1988, the U.S. taxpayers would be entitled to \$7,800 in personal exemptions and a \$5,000 standard deduction. As a result, their \$18,000 adjusted gross income in the example would be reduced to a taxable income of \$5,200. Applying a 15-percent tax rate, their tax liability would be \$780.<sup>5</sup>

Also, Puerto Rico's actual revenue for tax year 1983 was higher than our estimated federal revenue increase because the area's tax system did not allow the earned income credit. In 1983, about 29 percent of Puerto Rican taxpayers would have qualified for this federal income tax system credit.<sup>6</sup> (The credit would not have been available to the hypothetical taxpayers in our example because their adjusted gross income was higher than the maximum allowed.) Had the credit been available in Puerto Rico in 1983, Puerto Rico would have collected an estimated \$39 million less in personal income taxes.

Had federal income taxes replaced Puerto Rico's income taxes in 1983 and all else remained unchanged, individuals with low income would have benefited from the earned income credit and lower tax rates. Similarly, individuals with high income would have benefited from lower tax rates in the high income categories.

#### Officials' Views About Extending Federal Taxes

Puerto Rico government and business leaders' views frequently tied the prospective tax changes to the area's political status question. The question of whether Puerto Rico should become a state, continue as a commonwealth, or seek independence is a fundamental issue permeating many political decisions. The federal tax extension issue, therefore, raised questions not only about the possible impact of eliminating 936 tax credits, but also the potential effects on the island's fiscal autonomy and future relations with the United States. Some leaders also noted that, under current conditions, tax extension would be taxation without representation.

At the time of our review, those advocating continuing and strengthening the commonwealth arrangement controlled the governor's office and

<sup>5</sup>The above comparisons do not take into account income taxes that U.S. taxpayers may pay to the states in which they reside.

<sup>6</sup>Beginning in 1988, up to \$17,000 of adjusted income can be received, and credits up to \$300 can be received.



both houses of the legislature. They generally opposed removing the 936 tax credit. In testimony before the Congress, Puerto Rico's governor stated that repealing the credit would "devastate" Puerto Rico's economy. Commonwealth supporters in the legislature told us that repealing the credit would be particularly bad because the unemployment rate already at the time was very high (over 20 percent) and the economy was not strong enough to sustain and attract business on its own. Three of these legislators, including the Senate president, told us that local tax rates would have to be reduced if federal taxes were extended, thus reducing local revenues and restricting Puerto Rico's power to establish its own tax structure and to decide how tax monies may be spent.

Statehood advocates favored phasing in U.S. income taxes, if accompanied by statehood and correspondingly full participation in federal grant programs. Noting Puerto Rico's current dependence on the 936 tax credit, they favored phasing out the provision rather than eliminating it all at once. Two party leaders suggested to us that Puerto Rico could recoup income tax revenue losses by creating a sales tax, increasing property or excise taxes, or improving income tax enforcement.

Independence advocates opposed the imposition of U.S. income taxes. They favored tariff rights for Puerto Rico to protect domestic trade and retention of a relationship with the U.S. as a trading partner; they told us. According to one Independence Party leader, extending U.S. income taxes would constrain the government's capacity to raise essential operating revenues.

Generally, Puerto Rico department-level officials expressed views similar to those of the governor and key procommonwealth legislative officials. The Treasury assistant secretary for internal revenue told us that, were federal taxes imposed, Puerto Rico would have to reduce its own income tax rates and would probably have to compensate by cutting expenditures for government services. If the section 936 credit were removed, the Economic Development Office deputy director told us that unemployment would rise sharply. Puerto Rico's commerce secretary, assistant secretary, and executive assistant all told us the United States legally could not extend taxes to Puerto Rico and, that if this were done, it would spell disaster for Puerto Rico's fragile economy. The Economic Development Administration's legal counsel and chief of the planning section also envisioned an adverse impact from removing the credit and extending federal income taxes. These officials favored continuing and even enhancing current business incentives.

The Treasury assistant secretary, the former governor, the Senate majority and minority (Statehood) leaders, and the House president speculated that, were federal taxes imposed, Puerto Rico would have to adopt an area income tax at reduced rates. These officials did not believe the existing Puerto Rican income tax could continue, because the combined U.S. and area tax would be exorbitant. Some officials said operating revenue might be obtained through other means, such as imposing higher property taxes, but they doubted sufficient income could be generated to compensate for lost income tax revenue.

Business officials were nearly unanimous in opposing removing the section 936 tax credit and imposing federal taxes on Puerto Rico. Among their comments were the following:

- The market in Puerto Rico is not strong enough to attract business on its own; thus tax and other incentives are needed.
- The economy depends heavily on the credit, and tax exemptions are necessary to maintain Puerto Rico businesses' competitive standing.
- There would be a detrimental effect on local revenues with repeal of the credit, as business closings and unemployment narrowed the tax base.

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## Virgin Islands

Had federal income taxes been fully extended to the Virgin Islands for tax year 1983, federal revenue would have increased an estimated \$121.5 million. An estimated \$36.9 million would result from taxing corporations and \$84.6 million from taxing individuals.

## Corporate Tax Revenue

Virgin Islands corporations, which were taxed under the "mirror" provisions, generally would have been liable for the same taxes as under the federal income tax system. The major difference between the U.S. and Virgin Islands income tax systems was that certain corporations in the Virgin Islands qualified for rebates<sup>7</sup> of up to 90 percent of their area income taxes under an Industrial Development Program. To qualify in 1983, a corporation had to derive at least 80 percent of gross income from the Virgin Islands and at least 65 percent of gross income from active trade or business in the Virgin Islands. For tax year 1983, \$8.4 million was rebated under the Virgin Islands Industrial Development Program. If these rebates were added to the estimated \$28.5 million of

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<sup>7</sup>Rebates also were provided to some individuals, although such rebates were small, totaling only about \$84,000 in 1983.

corporate taxes collected in 1983 by the Virgin Islands, federal revenue would have increased by about \$36.9 million.

While U.S. corporations could not claim the section 936 tax credit for their Virgin Islands operations in 1983, they could claim the foreign tax credit for taxes paid to the Virgin Islands.<sup>8</sup> Data were not readily available on U.S. corporations that claimed the foreign tax credit for tax year 1983, but 28 firms claimed about \$5.0 million in such credits for tax year 1982. Moreover, prior to the Tax Reform Act of 1986, U.S. corporations and individuals who were inhabitants of the Virgin Islands fulfilled their federal income tax obligations by filing returns on and paying Virgin Islands income taxes.

To the extent businesses in the Virgin Islands might curtail operations or relocate outside the islands, federal revenue could be reduced. Our long-term estimate assumes that businesses receiving rebates in 1983 would relocate, thus reducing federal corporate revenues by the amount of the rebates. We assume no effect on personal income taxes.

#### Personal Tax Revenue

Assuming the federal income tax replaced the Virgin Islands income tax, federal personal income tax revenue is estimated to be virtually equal to the approximately \$84.6 million collected by the Virgin Islands for tax year 1983. The Virgin Islands' income tax system "mirrors" the U.S. Internal Revenue Code, resulting in similar income adjustments, exemptions, deductions, credits, and tax rates. Correspondingly, unless the Virgin Islands imposed a personal income tax in addition to the federal personal income tax, there would be virtually no difference for individual taxpayers.

#### Officials' Views on Extending Taxes

Virgin Islands officials expressed concerns about the possible effects of federal taxation on corporations. The governor told us he was "vehemently opposed" to extending federal income taxes. Further, he stated that (1) extension would be taxation without representation, and (2) the Virgin Islands' ability to attract business through tax incentives would be drastically inhibited by any action subjecting U.S. corporations operating in the Virgin Islands to U.S. taxation.

Government and business representatives echoed the governor's view that the ability of the Virgin Islands to attract businesses would be

<sup>8</sup>After 1985, corporations operating in the Virgin Islands could elect the section 936 credit.

severely harmed. Businesses had located in the Virgin Islands simply to take advantage of the preferential federal tax treatment, officials told us, and such businesses might move out and many jobs be lost. Some officials also speculated that businesses that remained would pass increased tax costs onto their customers.

According to the Internal Revenue Bureau director, the area likely would have to establish its own income tax system to compensate for operating revenue lost to federal taxes. However, he did not speculate about possible tax rates or provide other insights about the design of such a system for the area. Furthermore, he told us, an income tax surcharge, allowed under 1976 legislation, would have limited feasibility and cause problems for certain individuals. Among these would be new residents with much of their income generated outside the Virgin Islands and residents with investment income.

Extending federal income taxes would adversely affect the Virgin Islands' fiscal autonomy, according to some Virgin Islands' officials. Extending federal taxes would nullify the idea of Virgin Islands' self-sufficiency, the governor's Tax Task Force chairman told us. In addition to losing a large part of its operating budget, he said, the area would be unable to offer tax incentives to attract business investment, and would lose prospective and possibly established companies, as well as related jobs and job opportunities. Comments by the Internal Revenue Bureau director closely paralleled the Task Force chairman's views.

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## Guam

Had federal income taxes been fully extended to Guam in tax year 1983, the federal government would have gained an estimated \$90.9 million, including \$13.2 million from corporations and \$77.7 million from individuals. Like the Virgin Islands, Guam "mirrored" the U.S. Internal Revenue Code in 1983, with similar income adjustments, exemptions, deductions, credits, and tax rates.<sup>9</sup> Consequently, corporations and individuals paid the same taxes to Guam as would have been paid to the federal government under full federal taxation, except as noted below.

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<sup>9</sup>Under the Tax Reform Act of 1986, Guam is authorized to develop its own income tax laws.

A major exception was that Guam rebated part of its income taxes to certain corporations.<sup>10</sup> Guam operates an incentive program to encourage economic development; qualifying corporations receive such benefits as rebates of up to 100 percent of their area income taxes. To qualify, companies must meet general requirements such as increasing employment, replacing imports, and creating needed facilities. For tax year 1983, \$3.3 million in area income tax rebates were paid or owed to corporations.

U.S. corporations operating in Guam are eligible for certain credits. Qualifying U.S. corporations operating in Guam may opt to claim the section 936 tax credit. For tax year 1983, U.S. corporations operating in Guam claimed about \$1.7 million under this credit. Corporations that do not elect the credit may claim foreign tax credit against their federal tax liability for taxes paid to Guam. Data were not readily available on the amount of U.S. corporations' foreign tax credit claimed for taxes paid to Guam for tax year 1983, but 22 U.S. corporations claimed about \$2.5 million in such credits for tax year 1982.

Had federal income taxes totally replaced Guam's income tax in 1983, the effects on Guam's government operations could have been severe. Guam collected \$87.6 million for tax year 1983, including slightly over \$25 million remitted by the federal government for withholdings on federal employees who were Guam residents.<sup>11</sup> Income tax collections represented 38 percent of Guam's 1983 operating budget. Guam officials told us that, if this revenue were not recouped, government operations, including expenditures for education and infrastructure projects, would be negatively affected.

#### Officials' Views on Extending Taxes

The Guam legislature's vice speaker and the Planning Bureau director, along with business and academic representatives, told us that fully extending taxes would amount to "taxation without representation."

<sup>10</sup>While it allowed tax rebates by the Virgin Islands, the Internal Revenue Code in 1983 did not specifically allow Guam to rebate income taxes. However, in *Ramsey v. Chaco*, 549 F.2d 1335 (9th Cir. 1977), the U.S. Court of Appeals for the Ninth Circuit held that the provisions of Guam law granting income tax rebates to eligible investors are not violative of Guam's Organic Act, since the original law was impliedly approved by the U.S. Congress as provided for under section 19 of the Organic Act.

<sup>11</sup>Remittance of taxes withheld by the federal government to Guam was sizable in 1983 because over 10,000 active-duty military personnel and their families were stationed in Guam. Under the Tax Reform Act of 1986, U.S. agencies will not be required to withhold U.S. income taxes for U.S. employees in the insular areas if there is an agreement that allows the United States instead to withhold area income taxes. (Such an agreement can be made under title 5 of the U.S. Code).

Guam's governor, revenue and taxation director, and business community generally favored "delinkage" from the federal tax system (which was approved by the Tax Reform Act of 1986). They expressed a desire for flexibility in establishing their own tax system, leading to more revenue stability and a more competitive stance with their Asian neighbors.

Guam business leaders expressed less concern about the possibility of federal tax extension than did Puerto Rican or Virgin Islands business representatives. According to Chamber of Commerce officials, most companies were not profitable and thus would not pay U.S. taxes anyway. Chamber and other business officials also noted that the section 936 tax credit had not been of major importance in Guam. But Guam business representatives expressed concern about the impact of such tax changes on the area's ability to attract new businesses without being able to offer income tax rebates. Our long-term estimate of federal income tax revenues assumes no change from estimated 1983 levels of corporate or personal tax revenues.

Some business representatives said that, if Guam imposed an area income tax to compensate for lost operating revenue, the combined federal and area taxes would have a severe impact. Imposition of such taxes, they said, could cause some businesses to fold, and others to increase prices on products and services.

There were mixed views on the feasibility of making up lost revenue that would result from replacing area with federal taxes. According to the revenue and taxation director, some revenue could be made up through an area income tax. He added, however, that a tax saturation point would follow shortly because of Guam's low per capita income. Also, Guam's revenue might be increased by raising the area's gross receipts tax, he said, but noted that the legislature had been adamant about not raising this tax. Several officials suggested that lost revenue could be recouped by having the federal government pay property taxes or rent for the U.S. military's use of Guam land and facilities.

Imposing an area tax in addition to federal income taxes would be politically infeasible, the revenue and taxation director and a Guam legislator told us, noting that the governor had tried unsuccessfully for 3 years to invoke a 10-percent income surtax. The surtax was proposed to reduce the island's existing operating deficit. In addition, revenue bonds and spending cuts were seen as infeasible, as was asking the Congress for



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more money during a period of budget cutting. The governor and legislature members told us, however, that it should be the federal government's responsibility to make up the lost revenue.

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## American Samoa

Had federal income taxes been fully extended to American Samoa in 1983, the federal government would have gained an estimated \$14.3 million. This estimated federal revenue increase includes \$10.6 million from corporate and \$3.7 million from individual income taxes. In contrast, American Samoa's collections for tax year 1983 were \$13.2 million, including \$8.9 million from corporations<sup>12</sup> and \$4.4 million from individuals. The difference between our federal revenue estimate and actual area collections stems from differences between the U.S. and American Samoa tax systems.

Partial or full exemption of certain corporations' income taxes under American Samoa's economic development program kept the area's corporate income tax revenue for tax year 1983 about \$1.8 million less than federal income tax revenue would have been. To qualify, corporations must attempt to employ American Samoa residents so that they comprise at least 75 percent of a corporation's work force. For tax year 1983, four corporations received such tax exemptions.

The area's income tax collections from businesses also were less than federal tax revenues would have been because the area allowed investment credits for business property. Further, area revenue would have been higher had the government not agreed with the tuna canneries—the area's largest private sector employers—to exempt incorporated fishing vessels from area taxes on the vessels' income from selling fish to the canneries. Data were not available to determine the amount of revenue lost to American Samoa from these special tax provisions.

American Samoa collected about \$663,000 more in personal income taxes for tax year 1983 than we estimate the federal government would have collected. The difference represented the absence of the earned income credit, the area's minimum 2-percent personal income tax and special tax exemption for certain tuna boat workers, and the investment credit.

Had the federal income tax totally replaced the American Samoa tax in 1983, many area residents—particularly those no longer having to pay

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<sup>12</sup>Detail does not add to total due to rounding.

the minimum tax and those claiming the earned income credit—would have paid less income tax. On the other hand, tuna boat workers and those claiming investment credits would have paid more.

### Officials' Views on Extending Taxes

According to American Samoa government and business officials, removal of the 936 tax credit and the area's authority to grant income tax exemptions would have severe consequences. Testifying before the Congress in July 1985, the governor stated that "... To repeal the present system of 'possessions' taxation without the substitution of meaningful incentives ... poses a threat that the [tuna] canneries will leave American Samoa."

American Samoa's governor and business officials also told us that U.S. tax extension might cause the tuna canneries to leave, which in turn could have disastrous effects on the area's economy. One-third of American Samoa's employment is dependent on the tuna industry. In addition to contributing the largest portion of the area's revenue through taxes, they said, the canneries have a major effect on other businesses on the island, which might be lost if the canneries left. Cannery representatives told us that tax exemptions were the major reason for locating in American Samoa and loss of these incentives likely would cause them to leave the area. Lacking data to gauge these effects, we do not provide a long-term estimate of federal corporate or personal income tax revenues from American Samoa.

Federal income tax extension would cause American Samoa to become more fiscally dependent on the United States, which was counter to area aspirations, the governor told us. He said that American Samoa, to demonstrate it wanted to stand on its own rather than depend on the federal government, levied a poll tax before it adopted its current tax system.

The lieutenant governor questioned the legality of extending taxes to American Samoa, noting that the area had less than full representation in the U.S. Congress. Also, the Samoan Affairs Office's deputy secretary questioned the legality of the United States taxing Samoans, as they are not U.S. citizens.

The area government took the initiative to develop its economy rather than relying on the United States to do so, the governor's assistant for business and economic affairs told us. One tool used to attract outside investments, he pointed out, was the tax exemption American Samoa is

empowered to grant. If federal taxes were extended, they would lose this tool, he said, and thus have to rely more on the United States to develop their economy.

It would be difficult to impose an area income tax to compensate for revenue lost to federal taxes, American Samoa government officials told us. The governor did not believe his government could cut spending, he said, because too many people would become jobless. Officials generally felt that the only practical alternative would be to request additional funding from the United States to help recoup lost revenues.

# Conclusions, Matters for Congressional Consideration, and Agency Comments

Extending federal welfare programs and income taxes to the insular areas are controversial issues. While extending programs would sharply increase funds available for the needy, extending taxes would boost federal and reduce area revenues. Area officials generally favored program extension, especially SSI, although some officials in each area expressed reservations about extending some programs, especially title IV-E foster care. Area representatives almost unanimously opposed extension of U.S. taxes.

Program extension would bring about an estimated federal funding increase of about \$1 billion and an estimated \$90 million area cost decrease compared with 1984 levels. Fully extending the programs would allow for higher benefits, expanded services, and (except in Medicaid) more program participation. Also, many area residents, especially those in American Samoa, would receive benefits and services from some programs for the first time. Area officials' views on these programs were mixed, with the majority supporting extending most programs for the potential benefits noted above. Concerns were expressed about cultural disruption, increased welfare dependency and work disincentives, and potential alien immigration—which could increase the demand for welfare services and program costs.

Our program estimates are based on conditions at the time of our review and program design changes envisioned by area policy makers at that time. To the extent these would change, our program cost estimates would change. For example, were areas to establish higher AFDC payment standards than those identified during our review, AFDC costs would increase. Correspondingly, Medicaid costs would increase because the numbers of both "categorically needy" and "medically needy" eligibles would increase. Medicaid costs also would differ if areas elected program options causing their average benefit costs to be higher or lower than those of West Virginia—the state we used to estimate the areas' Medicaid costs. Changes in areas' economic conditions also might affect the demand for welfare services and, correspondingly, program costs. Finally, program costs might be affected by such legislative changes as the Immigration Reform and Control Act of 1986, which will increase the number of aliens entitled to welfare benefits.

Had federal income taxes been extended in 1983, U.S. revenues would have increased about \$2.7 billion and area revenues decreased about \$1.4 billion—assuming business activity levels remained unchanged. Annual federal revenues could decline over time to \$2.1 billion or less,

primarily because some U.S. businesses would close, relocate, or downsize their operations. Nearly all officials with whom we spoke opposed federal income tax extension, noting the potential adverse effects on area economies and government finances.

To the extent actual business activity in the areas differed from our assumptions, our estimates of tax revenue would change. Unemployment and economic slowdown resulting from reduced business activity could further reduce federal revenues and increase the demand for welfare. Also, were the areas to impose area income taxes, (1) areas' revenues would decrease to a lesser extent than we estimated and (2) estimated federal revenue would decrease to the extent such taxes were deductible in determining federal tax liability. Finally, federal tax revenue would be affected by such legislative changes as the Tax Reform Act of 1986, which (as expected) likely would increase corporate tax revenue and decrease personal tax revenue.

While the short-term net effect of program and tax extension could be an estimated increase in federal revenues and decrease in combined area revenues, GAO advises caution in using the program and tax estimates—given their susceptibility to variation. Smaller net federal revenue increases would result, for example, should extending taxes cause more businesses to relocate (thus increasing unemployment) and welfare services to be in greater demand than we estimated.

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## Matters for Congressional Consideration

There are inherent uncertainties involved in predicting the effects of fully extending welfare programs to the areas. Thus, should the Congress endeavor to make changes in the programs, it may wish to consider extending one program at a time to an insular area or subarea on an experimental basis. Area views about the programs would be useful in selecting such experiments. This would allow an opportunity to determine the actual cost effects and the nature and extent of other effects. Such an experiment—only one of several options (block grants, other specially tailored programs, waivers of program requirements, etc.) available for serving the areas—could be done as part of proposed welfare reform legislation, if enacted.

Similarly, should the Congress endeavor to make tax changes, it may wish to consider gradually increasing taxes—such as by partly reducing section 936 credits—to raise revenue to cover the cost of extending welfare programs. By so doing, taxes could be increased up to the cost of the programs, rather than totally eliminating tax incentives and other

special treatment and possibly jeopardizing the areas' economies and operating revenues. In addition, should the Congress consider extending U.S. income taxes to area residents and corporations, it may wish to assess the propriety of such actions in view of the issues raised by area officials.

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## Agency Comments

We received comments from Puerto Rico's governor, Senate president and resident commissioner; the Virgin Islands' governor; Guam's speaker of the Legislature; and American Samoa's governor and Senate president. We also received comments from the Departments of Agriculture, Treasury, Interior, and HHS. Although we provided the opportunity to comment, we did not receive comments by the time of issuance from Puerto Rico's House speaker, the Virgin Islands' Senate president, Guam's governor, or American Samoa's House speaker.

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## Puerto Rico

The governor of Puerto Rico opposed our suggestion that the Congress may wish to consider gradually increasing taxes—such as by partly reducing section 936 credits—to raise revenue to cover the cost of extending welfare programs. He observed that such “tinkering” with this highly successful tax provision, or even creating uncertainty about its continuation, would shut off new investment and hasten the departure of existing firms. He noted that any suggestion to amend section 936 to raise revenues appeared inconsistent with the report's assertions that federal tax benefits have been critical to Puerto Rico's industrial development and are likely to remain a major inducement for foreign investment.

We disagree that our suggestion is inconsistent with other report statements and note that the suggestion clearly is made within the context that, should the Congress endeavor to extend taxes, it may wish to consider doing so in a gradual rather than complete manner. We are not advocating that the Congress extend either welfare programs or taxes. However, if the Congress endeavors to do so, this approach likely would affect the areas' economies and operating revenues less adversely than, for example, would eliminating tax incentives for business altogether.

The governor said that our revenue estimates from full tax extension are overstated. He noted that the estimates do not account for the effects of the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982, the Tax Reform Act of 1986, the tax effects of the potential migration of



businesses and jobs from the area, or Puerto Rico's possible retention of area income taxes and their deductibility from federal tax liability.

We disagree. The report specifically acknowledges the possible effects of these and other matters on our estimates and otherwise qualifies the estimates as subject to variation and to be used with due care. For example, the report explains that data were insufficient to allow a projection of the tax effects that potential job losses may have, but specifies that such effects may occur and thus should not be disregarded when using the estimates. Also, although critical of our tax revenue estimates, the governor provided no alternative estimates, or additional data or suitable methodological bases for adjusting or reexamining the estimates.

The governor urged us to consider carefully the economic impact of repeal of section 936, as projected by ICF, Inc. In developing our estimates, we studied a number of reports on this issue, including Benefit-Cost Analysis of Section 936 and Data and Assumptions Used, Benefit-Cost Analysis of Section 936—both issued by ICF in September 1985. Although our methodology was somewhat similar to ICF's in estimating the number of firms, by industry, that would relocate outside Puerto Rico and the effect on federal tax revenues under full tax extension, the ICF methodology was not suitable for our study for a number of reasons. ICF assumed that some income from intangible assets would be sheltered from taxation, while we assumed, under repeal of section 936, full taxation of such income no matter where firms may relocate. Moreover, while ICF provides several alternative estimates and assigns probabilities to their occurrence, we found little in the reports to validate the probabilities assigned to each estimate.

The governor also said that, contrary to report statements, Puerto Rico's political relationship to the United States is not uncertain and, in fact, has been resolved by the courts. He cited several court cases that have held that Puerto Rico is not a "territory" and thus not subject to Congress' plenary powers. We note, however, that other court cases have held that Puerto Rico's status is that of a "territory." Although the majority of the cases that have mentioned the issue support the position that Puerto Rico's political status has changed, that status has not been precisely defined. Moreover, no case has decided whether the United States can unilaterally alter the U.S.-Puerto Rico tax relationship. Given these conflicting court opinions, we believe the issue has not been fully resolved.

Regarding program extension, the governor said that existing federal assistance does not satisfy the most basic needs of Puerto Ricans, noting that area residents who would be eligible for SSI now receive \$32 of monthly assistance compared with \$314 in the United States. The governor said that the amount of federal assistance for Puerto Ricans should be driven by need, just as for other U.S. citizens. The governor's views on this matter were incorporated in the report (see p. 35) along with those of other area policy makers.

The president of the Puerto Rico Senate, noting the extreme sensitivity of the report's subject, said he opposed the report because it addressed an issue that their administration was not currently pursuing and came at a time when the area was trying to rehabilitate its economy and build unity among the area residents. Both he and the governor said that the prospective changes would have a disastrous impact on their economy, noting closed manufacturing plants, stifled industrial growth, increased unemployment and welfare dependence, migration to the United States, reduced capital, increased interest rates, and reduced government services—partly resulting from the area's inability to make up lost revenue. The report discusses area officials' views on many of these matters.

The president's concerns were highlighted in an economic analysis of our report that he provided, An Analysis Of the General Accounting Office Report On 'Welfare and Taxes: Extending Benefits and Taxes To Puerto Rico, Virgin Islands, Guam and American Samoa' (Revised). The analysis, which reportedly was done using the Puerto Rico Senate's econometric model, narratively suggested that the adverse impact of fully extending income taxes and programs would be greater than we reported. For example, the consequent demand for welfare services would increase beyond our program cost estimates. The analysis also noted that our report did not explain fully our methodology for the long-term tax revenue estimate and that their evidence pointed to a radical change in the economy.

We recognize that fully extending U.S. income taxes may cause certain economic impacts as well as an increased demand for welfare, but again we point out in this report that available data were insufficient to properly gauge or quantify these possible effects. In this respect, once again neither the Senate president's nor the governor's comments provided sufficient information about the methodology and assumptions upon which their conclusions were based. Our methodology and each of the assumptions upon which our estimates are based are more fully discussed on pages 21 and 143-144.

Although we did not request his comments, Puerto Rico's resident commissioner also provided comments on the draft report. He criticized our review because it did not address the effects of extending all programs and did not adequately address the effects of extending the entire federal fiscal system to Puerto Rico. As requested, our study's design and scope were limited to projecting the effects of six federal programs and income taxes to the areas. The resident commissioner also observed that the data in the report were outdated. The data we reported, however, were the most recent available at the time of our work.

Several of his concerns appear to relate to the combined effects of program and tax changes. Specifically, he raised questions about the impact on Puerto Rico's debt as a result of losing local fiscal autonomy as compensation for equal treatment under federal programs. Similarly, he raised questions about the effects of eliminating section 936 of the U.S. tax code, in view of the uncertainty of whether Congress would enact "advantages" (presumably fully extended programs) as compensation for the negative impact of the tax changes on Puerto Rico. The report was not intended, however, to project the combined effects of program and tax changes, and we advise caution in using the interdependent estimates or netting the effects because the individual cost and revenue estimates are subject to variation.

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## Virgin Islands

The Virgin Islands' governor emphasized his vehement opposition to "tax retention" by the United States due to its potentially devastating effects—lost operating revenue, increased unemployment, and welfare participation. He also questioned the propriety and equity of the United States unilaterally taxing the Virgin Islands, especially when residents have no effective way to influence U.S. tax or other policy because they have no vote. Such taxation without voting representation, he pointed out, is not only wrong, but is as repugnant as it was "to the drafters of the Declaration of Independence."

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## Guam

The speaker of Guam's legislature noted that U.S. income tax extension would have disastrous effects and create tremendous social trauma and characterized such a prospect as "taxation without representation." Also, he expressed concern that Guam's unique situation was not emphasized. While noting that changes in the area by federal initiatives such as improvements to the area's infrastructure and health and education programs had helped Guam, he asserted that U.S. contributions had

been sporadic and piecemeal. He reiterated Guam's desire for full extension of all six programs, including SSI, which already is available in the neighboring Northern Mariana Islands. But he noted that Guam's current need for federal assistance stems from earlier federal policies rather than the island's remote location and unique character. Specifically, federal trade legislation and military land use caused the area to change from an agrarian to a monetary economy, he said, inhibiting growth, self-sufficiency, and independence.

While some of these issues were beyond the scope of our work, we included additional information in our report (see p. 12) to place Guam's unique historical and economic development in better perspective.

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## American Samoa

American Samoa's governor and the president of its Senate reemphasized the area's opposition to program extension because of the potential adverse effects on their culture and tradition, increased welfare dependency, and work disincentives. Both said that benefits might be outweighed by the social costs. However, the governor expressed American Samoa's continuing need for services provided by Medicaid in its current form to preclude welfare stigma and the administrative burden of fully extended Medicaid. But he suggested increasing the existing funding ceiling, saying that the preponderance of evidence justified its removal. The report discusses the various area officials' views on these matters.

Both the governor and the president observed that a proportion of American Samoa's residents are aliens. The governor, noting existing economic and social hardships associated with these aliens, expressed concern that more aliens might migrate to the area to take advantage of fully extended welfare programs. But because alien residents might not qualify for the programs, the Senate president said, the program cost and participation estimates might be too high.

Our report points out that we could not estimate, nor did the governor or president, the number of aliens that might migrate to the area. Also, it is uncertain how many of such aliens' immigration status would make them eligible for welfare benefits. Moreover, the Immigration Reform and Control Act of 1986 could affect aliens' eligibility for the programs, and the Act's applicability to American Samoa currently is uncertain. Thus, as the report points out, we were unable to adjust our program cost estimates to account for possible increased alien migration to the area.

Also, the president said, American Samoa's "extended family culture" might create a situation where federal programs easily could be abused. For example, persons could easily claim numerous dependent children, absent spouses, and lack of household income, he suggested. Our data were insufficient to adjust our estimates for these situations.

Fully extending U.S. income taxes would be disastrous, both the American Samoa governor and Senate president reiterated, especially if the tuna canneries relocated off the island. The governor said that area revenue, which had changed over the last few years due to tax law changes, would decline, undermining the area's chances for self-sufficiency, as would business activity, and unemployment would increase. Ultimately, he noted, the expected federal revenue would not increase. Instead of extending taxes, which might drive away businesses, the Senate president said, the area needed additional incentives to attract business and stimulate economic growth. Our report discusses the various area official's views on these matters.

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## Federal Agencies' Comments

According to the Department of Agriculture, our report did not show the significance of Food Stamps in the areas and the counterpart Nutrition Assistance Program in Puerto Rico—which are an indication of the federal commitment to the areas. While we did not analyze the comparative significance of the programs in our report, we did show the actual and estimated expenditures and participation rates for each program in each area. Food Stamps and Puerto Rico's counterpart program were clearly the largest programs. We believe that comparison of these figures in table 1.1, which shows such selected characteristics as the areas' populations, places the significance of the programs in perspective.

The Treasury, in addition to providing technical comments, said that our long-term estimate of the revenue effects of tax extension was highly speculative and thus should be qualified and deemphasized. We believe the report properly characterizes the estimates, but did revise appendix V (see pp. 143-144) to explain more fully the basis for our long-term estimates. We also believe it is important for the Congress to understand that increased tax revenues—estimated at \$2.7 billion for all four areas for 1983—likely would be much smaller over the long term, after businesses and the areas had time to fully react to such changes.

Also, Treasury said our reference to "tax year 1983" is not clear and that corporate tax data used in the report do not reflect the effects of TEFRA. We have defined more clearly "tax year 1983" (see p. 21). Our



estimates largely reflect post-TEFRA tax data and we could identify no methodological basis for adjusting the relatively small portion of our data that were pre-TEFRA. Thus, we added a qualifying statement to indicate our estimates may be over- or under-stated depending on TEFRA's effects. Treasury also observed that the significance of intangibles might be understated (see p. 143), and that our report did not consider the tax cost of transferring intangibles outside the United States. Under fully extended taxes, however, there would be no tax effect from transferring intangibles because section 936 of the Internal Revenue Code—which currently allows special treatment for intangibles—would be eliminated. Treasury also said the report did not clearly indicate why we assumed area income taxes would be replaced by federal taxes and questioned our use of the 2.35 indirect employment “multiplier” for section 936 credits in Puerto Rico. We clarified our rationale for not attempting to adjust our tax revenue estimates to reflect the possible continuation or establishment of area income taxes (see p. 21), and deleted our reference to that particular indirect employment “multiplier” effect.

Interior said it adamantly opposed fully extending additional programs or income taxes to the areas, citing the Department's objectives of promoting self-government and self-determination by the areas' residents. Interior suggested that areas would have difficulty meeting matching requirements; the bureaucracy to administer them would bankrupt the islands fiscally and morally; and area cultures would be adversely affected. We agree that these are all matters the Congress likely will have to weigh should it endeavor to extend programs and taxes. As discussed in the report, however, most area officials expressed to us a desire and need for additional, fully extended programs.

Noting that the report was a fair and accurate description of the Department's area programs, HHS' comments, for the most part, were technical. We did change the matters for congressional consideration (see pp. 73-74) to suggest that extending programs on an experimental basis could be done as part of proposed welfare reform legislation, if enacted, and noted such an approach is only one of several options for serving the areas' programmatic needs.



# Descriptions of Six Federal Welfare Programs Reviewed and Area Counterparts

The six welfare programs covered by our review and their area counterparts as they operate in Puerto Rico, the Virgin Islands, Guam, and American Samoa are described in this appendix. Each program description includes its legislative authority, eligibility requirements, benefits, and funding arrangements. Selected program statistics are presented at the end of the appendix.

## Supplemental Security Income

SSI is a nationwide, federally funded and administered program through which income assistance is provided to persons who are age 65 or older or blind or disabled and whose income and resources are below specified levels. Cash payments are made directly to program participants, with no restrictions on how the funds may be used. SSI is available in the 50 states, the District of Columbia, and the Northern Mariana Islands. SSI replaced federal/state programs--adult assistance programs through which cash assistance was provided to needy aged, blind, or disabled persons; these programs still exist in Puerto Rico, the Virgin Islands, and Guam. Neither SSI nor adult assistance programs are available in American Samoa.

### Authority

SSI was established in 1972 under Public Law 92-603 and became effective January 1, 1974, as title XVI of the Social Security Act, as amended.

### Eligibility Requirements and Benefits

Program eligibility and benefits are based on federally established physical and financial criteria. To qualify, a person must have attained age 65; be blind—have 20/200 vision or less in the better eye, with a corrective lens; or be disabled—unable to engage in substantial gainful activity due to a medically determined physical or mental impairment expected to result in death or that has lasted or is expected to last continuously for 12 months. In addition, the individual must be a resident of the United States and a citizen or alien lawfully admitted for permanent residence in the United States or under certain other conditions.

The amount of income an individual may receive and be eligible for SSI benefits depends upon the person's marital status and type of income, as well as living arrangements. Income of an ineligible spouse living with an adult SSI applicant or recipient or the parents of a disabled or blind child under age 18 is generally deemed available to the applicant or recipient, after excluding funds needed for other household members.

When determining benefits, certain income is disregarded, including but not limited to

- needs-based payments made by a state or one of its political subdivisions;
- \$240 of any income, other than needs-based income;
- infrequent or irregular unearned and earned income totaling less than \$20 and \$10 per month, respectively;
- in the case of a blind person under age 65, \$780 annually of earned income, plus half the balance, up to the maximum benefit, plus expenses related to earning the income and the cost of fulfilling a plan to achieve self-support;
- in the case of a disabled person under age 65, \$780 annually of earned income, certain expenses related to earning the income, half the balance not already disregarded, and the costs of fulfilling a plan to achieve self-support;
- foster care payments for a noneligible child placed in the home by a public or nonprofit agency; and
- one-third of the child support payment from an absent parent.

For 1984, the maximum monthly benefit levels for persons living in their own household were \$314 for an individual and \$472 for a couple. Assuming a \$240 disregard, the maximum annual income in 1984 for SSI was \$4,008 for an individual and \$5,904 for a couple, respectively, if receiving only social security, and \$8,556 and \$12,348 for individuals and couples, respectively, if receiving earned income.

In 1984, if an individual lived with an essential person—generally one whose needs were considered in qualifying for former adult assistance program payments but who was not eligible for SSI, such as an ineligible spouse—an additional \$157 per month was allowed. On the other hand, if the participant lived in another person's home and received such in-kind assistance as room and board, the participant's benefits were reduced by one-third. If the participant was institutionalized in a facility for which Medicaid pays most of the bill, his/her benefits were limited to \$300 per year, or \$600 if both husband and wife were eligible and residing in such a facility. Finally, persons in public institutions, except publicly operated community residences with fewer than 16 people, or temporary residents in a public emergency shelter generally were ineligible for SSI.

Additionally, individuals and couples must meet resource criteria. In 1984, an individual with an eligible spouse or living with an ineligible

spouse could qualify for SSI if, after excluding specified assets, his/her resources were no more than \$2,250. For an individual without a spouse, the countable resources were limited to \$1,500. The following are examples of assets excluded from resources in determining these limits:

- The home and attached land;
- Household goods and personal effects, with equity values not in excess of \$2,000 (established by HHS);
- An automobile, regardless of value, if necessary for employment or medical treatment or if modified for use by a handicapped person; if none of these "use" exclusions apply, the first \$4,500 in market value for one automobile (established by HHS);
- Burial space;
- Life insurance, with a face value not in excess of \$1,500;
- Up to \$1,500 of certain burial funds (the amount is reduced for up to \$1,500 face value of any life insurance excluded from resources);
- Up to \$6,000 equity in property essential to being self-supporting provided it returned at least 6 percent annually of the amount excluded; and
- Resources (for up to 48 months) of blind or disabled persons set aside under a plan to achieve self-support.

Certain individuals are deemed to meet income or resource requirements. Resources of persons who received adult assistance for December 1973 and who have continued to reside in the state and have been continuously eligible for SSI are deemed within SSI requirements if they do not exceed the limit imposed by the adult assistance state plan in effect on October 1972. Similarly, anyone who received adult assistance and continued to meet the program requirements shall have disregarded the greater of (1) the allowable income disregards under SSI or (2) the former adult assistance program.

In 1984, average individual monthly benefit levels for the aged, blind, and disabled were \$143, \$224, and \$230, respectively. For couples, average monthly benefits were \$222, \$304, and \$272, respectively.

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## Funding Arrangements

SSI, which is 100-percent federally funded, is an open-ended authorization for appropriations—it has no federal funding limit.

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## Adult Assistance Programs

Adult assistance programs are formula grants<sup>1</sup> through which cash assistance is provided to needy aged, blind, or disabled individuals. Adult assistance programs are jointly funded by the federal and area governments and administered by the areas. Each area establishes its eligibility criteria and benefit levels within the limits of federal law and regulations and in accordance with a plan approved by HHS.

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### Authority

Adult assistance programs are authorized by different titles of the Social Security Act, as follows:

- Old Age Assistance - title I (42 U.S.C. 301, note),
- Aid to the Blind - title X (42 U.S.C. 1201, note),
- Aid to the Permanently and Totally Disabled - title XIV (42 U.S.C. 1351, note), and
- Aid to the Aged, Blind or Disabled - title XVI (42 U.S.C. 1381, note).<sup>2</sup>

Guam and the Virgin Islands operate separate programs for each needy group. Puerto Rico operates the combined Aid to the Aged, Blind, or Disabled Program.

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### Eligibility Requirements

To receive federal funds, areas are required to have adult assistance plans, approved by HHS, which meet federal requirements set forth in applicable federal law and regulations. For example, the areas' plans must assure that adult assistance beneficiaries meet physical and financial requirements. However, the areas have great flexibility in designing their programs.

Federal law requires that adult assistance recipients meet physical criteria similar to SSI's—be 65 years old, blind, or disabled. Blindness and disability are not defined, but federal regulations require the insular area plans to define them and recommend definitions.

The federal government prescribes overall requirements, but the areas establish specific income and resource eligibility requirements and benefit levels. The federal government requires the areas to consider all

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<sup>1</sup>Formula grant funds are generally allocated according to a distribution formula prescribed by law or regulations.

<sup>2</sup>Title XVI of the Social Security Act as it existed prior to 1972 authorized states and certain U.S. insular areas to consolidate titles I, X, and XIV programs into one—the Aid to the Aged, Blind, or Disabled Program.

income and resources in determining eligibility, and sets forth the following parameters for income disregards:

- Old Age Assistance - Up to \$7.50 per month of any income may be disregarded. The first \$20 plus half the remainder of the first \$80 per month of earned income may be disregarded.
- Aid to the Blind - The first \$85 per month plus half the remainder of all earned income shall be disregarded. Income and resources related to achieving a plan of self-support must be disregarded for up to 12 months and may be disregarded for up to 36 months. The first \$7.50 per month of any income may be disregarded also.
- Aid to the Permanently and Totally Disabled - The first \$7.50 per month of any income, the first \$20 plus half the balance of the first \$80 per month of earned income, and income and resources related to fulfilling a self-support plan for up to 36 months may be disregarded.

Allowable disregards differ among the three areas. With respect to the aged program in 1984, all three areas allowed the \$20 disregard per month, plus half the remainder of the first \$80 of earned income; only the Virgin Islands allowed an additional \$5 disregard. For the blind, all three areas disregarded the first \$85 of earned income, plus half the excess up to the maximum benefit; Puerto Rico and the Virgin Islands disregarded income and resources needed to fulfill self-support plans, up to 36 and 24 months, respectively, and the Virgin Islands allowed an additional \$5 disregard. All three areas' disabled disregards were the same as their aged disregards, except the Virgin Islands disregarded income and resources needed to fulfill a self-support plan for the disabled for up to 36 months.

Through federal regulations, HHS sets forth basic resource parameters. The potential participant's home, automobile, personal effects, and income-producing property may be excluded when determining compliance with resource limitations. Excluding those items, the amount of assets can be no more than \$2,000 per individual.

Resource limits varied for the areas in 1984. Puerto Rico allowed cash assets up to \$2,000 per individual, in addition to the home, home furnishings, personal effects, livestock, and poultry used by the family, a car, and income-producing property. The Virgin Islands allowed assets up to \$500 for an individual or \$1,000 for two or more persons, plus a life insurance policy with a face value up to \$500, a home, household

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furnishings, clothes, a car, personal effects, and "reasonable" income-producing property. In addition to a home, personal effects, and nonincome-producing property, Guam allowed assets up to \$1,000 per household.

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## Benefits

Federal regulations require the establishment of a need and payment standard. A need standard is the amount of funds needed to meet daily living requirements. A payment standard is the percentage (up to 100 percent) of the need standard the area will pay. Each area establishes its own eligibility/benefit level.

In 1984, the basic monthly individual need standards for Puerto Rico, the Virgin Islands, and Guam was \$64, \$100, and \$60 respectively. (Unlike SSI, adult assistance programs view persons individually, not as couples. Two qualified persons living together—married or not—would be eligible to receive double the areas' individual payment standards.)

In addition, each area provided funds for special needs, which they define. Puerto Rico paid 50 percent of its recipients' shelter costs. Guam provided up to \$85 per month for such special needs as shelter and utilities. The Virgin Islands provided up to \$75 per month for such special needs as nursing care and home repairs.

Each area had a different payment standard. Puerto Rico paid 50 percent of its need standard; the Virgin Islands, 82 percent; and Guam, 100 percent.

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## Funding Arrangements

The areas' adult assistance federal financial participation rates were 75 percent for benefits and training and 50 percent for other administrative costs. Federal funding for each area's combined expenditures for adult assistance, AFDC, and title IV-E foster care was capped.

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## Aid to Families With Dependent Children (AFDC)

AFDC is a formula grant to the 50 states, District of Columbia, Puerto Rico, the Virgin Islands, and Guam through which cash payments are provided for needy children (and their caretaker relatives) who are deprived of parental support. It is administered by each state and area in accordance with a plan approved by HHS. AFDC is not extended to American Samoa.



<b>Authority</b>	AFDC is authorized as title IV-A of the Social Security Act, as amended. (42 U.S.C. 601)
<b>Eligibility Requirements</b>	<p>States and areas define need, establish income and resource requirements, and set benefit levels within federal limits.</p> <p>AFDC assistance is provided to needy children, generally under 18, deprived of support because of their parents' continued absence from home, incapacity, death, or—at state and area option—unemployment of the principal wage earner.</p> <p>Generally, all persons 16 years of age or older who are receiving or applying for AFDC must register for work and training. However, they may be exempt from this requirement due to illness, incapacity, advanced age, full-time student status, remoteness from a "work incentive" program site, need to care for an ill or incapacitated member of the household, working at least 30 hours per week, or need to care for a child under 6 years of age. (In a two-parent family, one parent is exempt if the second parent is registered for work.) AFDC mothers must give up child support rights to the state or area.</p> <p>States and areas may opt to provide assistance to (1) two-parent families in which the primary wage earner is unemployed, (2) certain pregnant women during their last 4 months of pregnancy, and (3) 18-year-old children who are full-time students in a secondary or technical school and may reasonably be expected to complete the program before reaching age 19. Additionally, emergency services may be funded, and coverage may be extended to "essential persons"—individuals determined essential to a recipient's well-being. The areas' coverage of these groups varies, as table I.1 indicates.</p>

**Table I.1: Coverage of Selected AFDC Options by Puerto Rico, the Virgin Islands, and Guam (1984)**

Option	Area		
	Puerto Rico	Virgin Islands	Guam
Serve families with unemployed person	No	No	Yes
Serve pregnant women with no other children	No	No	Yes
Serve 18-year-old students	No	Yes	Yes
Provide "emergency services"	Yes	Yes	No
Cover persons essential to recipients' well-being	Yes	No	Yes

Generally, the gross income of any child or relative claiming AFDC, including certain income of stepparents and the income of an alien's sponsor, deemed available to the applicant, must be below 185 percent of the applicable need standard<sup>3</sup> established by the state or area in which the applicant resides. Additionally, countable income—gross income minus disregards for earned and unearned income—must be below the applicable need standard. Some federally mandated income disregards in 1984 included

- earned income of AFDC recipient children who were full-time students or part-time students who did not work full time,
- the first \$75 of monthly earned income of any child or relative applying for or receiving AFDC,
- certain child and dependent care costs up to \$150 per month per child or incapacitated person,
- the first \$30 of earned income not already deducted plus one-third of the balance up to the maximum time allowed, and
- the first \$50 per month in any child support payments.

States also have the option to disregard certain other income of a dependent child, including up to 6 months of income from the Job Training Partnership Act.<sup>4</sup>

In addition to income criteria, AFDC applicants must meet resource requirements. The value of resources is limited to \$1,000, excluding (1) a home, (2) an automobile with equity value up to \$1,500, and (3) burial plots and funeral agreements valued up to \$1,500 per person.

## Benefits

Cash payments generally are provided for families whose countable income is less than the payment standard.<sup>5</sup> In 1984, 17 states (plus Guam) had payment standards equal to their need standard for various size families; thus, payments to eligible families amounted to the difference between countable income and the need standard. In three other

<sup>3</sup>Need standard is the money amount a state or area determines is essential to purchase basic consumption items. The standard is related to the number of persons in the assistance unit.

<sup>4</sup>The Job Training Partnership Act of 1932 (Public Law 97-300) provides formula grants for job training and related assistance to economically disadvantaged individuals and others who face significant employment barriers.

<sup>5</sup>Payment standard is the maximum amount a state will provide to a family of a given size with no countable income and from which the state subtracts income to determine the family payment; it may be equal to or less than 100 percent of the need standard.

states, such payments were made to smaller size families but were reduced for larger families. In the remaining 30 states (plus the District of Columbia, Puerto Rico, and the Virgin Islands), payments to all size families were less than full needs minus countable income, because the payment standard was less than the need standard. Table I.2 shows applicable standards for the areas.

**Table I.2: AFDC Need and Payment Standards for Puerto Rico, the Virgin Islands, and Guam (1984)**

Number of children plus caretaker	Areas <sup>a</sup>					
	Puerto Rico		Virgin Islands		Guam	
	Need	Payment	Need	Payment	Need	Payment
1	\$112	\$56	\$154	\$126	\$120	\$120
2	160	80	209	171	165	165
3	208	104	263	215	210	210

<sup>a</sup>Puerto Rico also pays 50 percent of the recipient's shelter costs. Guam provides up to \$145 per month for such special needs as shelter and utilities. The Virgin Islands provides up to \$75 per month for such special needs as nursing care and home repairs.

## Funding Arrangements

Federal AFDC funding for states is open-ended, while federal funding is capped for areas' combined AFDC, adult assistance, and title IV-E foster care expenditures.

States and areas may request federal reimbursement using a prescribed formula or the federal financial participation rates for Medicaid. Currently, all states use the Medicaid rate, which may legally range from 50 to 83 percent, depending on per capita income. For AFDC reimbursement purposes, the areas' Medicaid rate is set by federal law at 75 percent. The reimbursement rates for state and area administrative costs is 50 percent, except for planning, design development, and installation of certain mechanized claims processing and information retrieval systems, which are shared at 90 percent.

## Medicaid

The Medicaid program is a formula grant available to the 50 states, the District of Columbia, Puerto Rico, the Virgin Islands, Guam, American Samoa, and the Northern Mariana Islands. Funds are provided for medical assistance to low-income persons who are aged, blind, disabled, or members of families with dependent children. The program is essentially designed and administered by the states and areas, within federal limits and in accordance with plans approved by HHS.

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## Authority

Medicaid was enacted in 1965 (Public Law 89-97) as title XIX of the Social Security Act, as amended (42 U.S.C. 1396).

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## Eligibility Requirements

States and areas must serve the categorically needy, including (1) recipients of cash under adult assistance, SSI, mandatory SSI supplements, and AFDC and (2) individuals receiving foster care under title IV-E.

In addition, they may serve individuals who meet the requirements to receive cash assistance, but do not receive cash. Also, services may be provided to persons who are aged, blind, disabled, dependent children, caretaker relatives of dependent children, persons essential to SSI recipients, or certain pregnant women and whose income and resources are insufficient to meet medical costs. This last group—the “medically needy”—generally (but not in the areas) may not have gross income in excess of 133-1/3 percent of the state’s AFDC payment standard for a family of the same size.

Puerto Rico, the Virgin Islands, and Guam have opted to serve

- persons eligible for but not receiving adult assistance or AFDC;
- persons in a medical facility who, if they left the facility, would be eligible for cash assistance;
- the spouse of an adult assistance recipient who is living with the recipient and determined to be essential to the recipient’s well-being;
- all individuals under age 21 who would be eligible for AFDC except that they do not qualify as dependent children; and
- individuals who would be eligible for adult assistance or AFDC if the areas’ coverage were as broad as allowed under the federal law, including families with unemployed parents.

Puerto Rico and the Virgin Islands also serve certain “medically needy” individuals who, except for income limits, would be eligible as cash assistance recipients or under one of the above optional groups. However, such coverage is limited to (1) pregnant women, (2) individuals under 21, (3) caretaker relatives, (4) the aged, (5) the blind, (6) the disabled, and (7) eligible spouses of aged, blind, or disabled individuals. Guam stopped serving the “medically needy” in January 1985.

Unlike states, areas are exempt from the requirement that the incomes of the “medically needy” be under 133-1/3 percent of the applicable AFDC payment standard for a family of the same size. Historically, the areas also have been exempt from the requirement that beneficiaries be given

a freedom of choice of service providers—a requirement for all states until 1982.

A brief description of each of the three areas' income and resource criteria for the "medically needy" follows.

- Puerto Rico - The 1984 income limits for the "medically needy"—\$3,750 for one person and \$4,800 for two, plus \$900 for each additional person—was substantially above the area's \$384 annual AFDC payment standard per individual. The area's resource limit for "medically needy" individuals was \$500, plus \$100 for each member of the household. Exempted resources included the family's home, personal property, and income-producing real estate and other real property with a value up to \$10,000. In addition, \$500 for education, investment, or business could be exempted for a period of 12 months.
- Virgin Islands - The Virgin Islands' "medically needy" income limit—\$3,000 for one person, plus \$500 for each additional person—was substantially higher than its annual \$1,515 AFDC payment standard. A "medically needy" person could not have resources exceeding \$1,500, plus \$100 for each additional family member. (Real property other than a home and rental property in excess of \$10,000 was considered a resource.)
- Guam - Although the income limits for the "medically needy" (until Guam discontinued its "medically needy" program) were the same as those for the adult assistance and AFDC programs, the limits on assets were different. Excluding a home, one vehicle, and basic essential items for day-to-day living, limits on assets were \$1,200 for one person; \$1,500 for a family of two persons, plus \$150 for each additional person up to seven; and \$2,500 for a family of eight, plus \$150 for each additional person.

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## Benefits

Benefits are provided in the form of medical services. At minimum, the following services must be provided to the individuals required to be served:

- Inpatient hospital services;
- Outpatient hospital services;
- Rural health clinic services, consistent with local law;
- Laboratory and X-ray services;
- Skilled nursing facility services for individuals over age 21;
- Home health services for those entitled to skilled nursing care;

- Early and periodic screening, diagnosis, and treatment for individuals under age 21;
- Family planning services and supplies;
- Physicians' services; and
- Services of nurse-midwives, consistent with local laws.

The areas provide most mandatory services to Medicaid eligibles. However, Puerto Rico offers family planning services, limited skilled nursing facility services, and early and periodic screening and diagnosis services without claiming Medicaid federal financial participation. According to area officials, the Virgin Islands have no skilled nursing facilities; such services are provided to Medicaid eligibles in the hospital without claiming federal Medicaid reimbursement.

At state and area option, other services may be provided, including prescribed drugs, intermediate care facility services, eyeglasses, dental services, and inpatient psychiatric care for individuals under age 21 or over age 65.

States and areas may establish limits on the amount of medical care provided. For example, states may limit the number of days of covered hospital care or the number of physicians' visits covered by Medicaid. They also establish the payment level for services, such as payments for physicians' visits or skilled nursing care.

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## Funding Arrangements

Federal funding for the Medicaid program in the states is open-ended; it is capped in the areas. The federal financial participation rate for states' Medicaid benefits (except family planning, which is reimbursed at 90 percent) is based on a formula taking into account the state's per capita income, with limits that may be no lower than 50 percent and no higher than 83 percent. The rate for areas is set by federal law at 50 percent, up to the funding cap. The sharing rates for administrative expenses are 75 percent for training, conducting utilization review, and operating mechanized claims processing, information retrieval, fraud control, and hospital costs-determination systems; 90 percent for establishing the mechanized claims processing and fraud control systems; and 50 percent for the remaining administrative costs.

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The secretary of HHS may waive all requirements for American Samoa's Medicaid program except those that require funds be spent on allowable medical services, impose a ceiling on available federal funds, and limit



the reimbursement rate. Under a unique program established under this authority in American Samoa, individuals do not have to meet income and resource criteria to qualify for Medicaid. Instead, all American Samoans receive medical services from the area's public health service providers at little or no charge. Medicaid reimbursement is based on an annual estimate of the number of American Samoa residents presumed eligible for Medicaid benefits—the number of persons who fall below the American Samoa poverty level, which is determined by the area government. Total federal reimbursement is limited to the area's federal funding ceiling.

## Foster Care

Foster care encompasses (1) maintenance payments covering the costs of food, clothes, shelter, daily supervision, and other necessities and (2) social services aimed at assuring adequate care of children away from home because both parents are absent, incapacitated, or otherwise unable to provide adequate care. Federally funded foster care is provided in the states, the District of Columbia, and areas, except American Samoa.

## Authority

Federal foster care funding is provided under three titles of the Social Security Act:

- Child Welfare Services - title IV-B (42 U.S.C. 620),
- Federal Payments for Foster Care and Adoption Assistance - title IV-E (42 U.S.C. 670), and
- Block Grants to States for Social Services - title XX (42 U.S.C. 1397).

## Eligibility Requirements and Benefits

Title IV-B funds can be used for child welfare services aimed at protecting and promoting the welfare of children, including foster care maintenance payments. Title XX funds can be used to provide a variety of social services, including foster care services other than maintenance payments. Title IV-E provides funding for foster care maintenance payments for children who otherwise would be eligible for AFDC. There are no federally mandated income or resource eligibility requirements for title IV-B and XX services.

## Funding Arrangements

State and area funding levels for each of these programs vary and are based on formulas taking into consideration per capita income, the number of children in the state or area, and other factors. The federal

sharing percentages for the three programs also vary, with title IV-B reimbursed at 75 percent and title IV-E program and administrative costs reimbursed at 75 and 50 percent, respectively. Title XX, which is a block grant, has no sharing arrangements.

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## Child Support Enforcement

The Child Support Enforcement Program is designed to enforce the support obligations owed by absent parents to their children and the spouse (or former spouse) with whom the children are living. The program encompasses locating absent parents, establishing paternity, and obtaining child and spousal support. To locate parents and obtain support, several types of enforcement tools may be used including garnishment of wages, withholding of income tax refunds, and use of the courts for enforcement of support orders. The program is provided to the 50 states, District of Columbia, Puerto Rico, the Virgin Islands, and Guam. It is not extended to American Samoa.

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## Authority

The program was established in 1975 (Public Law 93-647) as title IV-D of the Social Security Act, as amended (42 U.S.C. 651).

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## Eligibility Requirements and Benefits

Child Support Enforcement services are offered to both AFDC and non-AFDC children. With respect to AFDC families, recipients must assign to the states or areas any rights to support from any other person and must cooperate in establishing paternity for out-of-wedlock children. As of October 1984, support payments except for the first \$50 per month have been collected by the state as an offset for the AFDC payments made to that family.

Non-AFDC families who file applications for services must be given the same child support collection and paternity determination services given AFDC families. Non-AFDC families are charged an application fee, which may be paid through state funds or recovered from the noncustodial parent. The state must continue to provide child support services to families whose AFDC eligibility ends due to the receipt of child support payments, and no application fee may be charged.

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## Funding Arrangements

As of 1984, the federal government provided 70 percent of the cost of Child Support Enforcement on an open-ended basis. (The rate was reduced to about 67 percent in 1986 by the Balanced Budget and Emergency Deficit Control Act of 1985.) States that elected to establish an

automatic data processing and information retrieval system received 90 percent federal funding for such expenses. In addition, there was an incentive system designed to encourage state and local government participation in the program.

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## Food Stamp Program

The Food Stamp Program is designed to improve the diets of low-income households by increasing their food purchasing power through the provision of coupons, which may be used to buy certain food and food-stuffs. The program is available in the 50 states, the District of Columbia, the Virgin Islands, and Guam. A simpler, modified program operates in the Northern Mariana Islands. The Food Stamp Program was replaced in Puerto Rico in 1982 by the Nutrition Assistance Program. The Food Stamp Program is not extended to American Samoa.

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## Authority

The Food Stamp Program, which was established by the Food Stamp Act of 1964 (Public Law 88-525), has been revised several times, including substantial revision by the Food Stamp Act of 1977 (Public Law 95-113) (7 U.S.C. 2011).

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## Eligibility Requirements

Food Stamp eligibility is based primarily on financial need. Persons must meet federally prescribed income and resource criteria. In addition, able-bodied persons must register for work with certain exceptions, such as when they are (1) caring for children under age 6 or disabled persons, (2) subject to other program work requirements, (3) working 30 hours per week or earning minimum wages, (4) less than 18 year of age, or (5) disabled or elderly. U.S. citizens, aliens admitted for permanent residence, and certain other aliens may qualify.

Gross income criteria is anchored to the U.S. poverty level set by the Office of Management and Budget, which was \$10,200 in 1984 for a family of four. The monthly gross income of applicant households—generally all individuals living together and buying food and preparing it in common—with no disabled or aged members may not exceed 130 percent of the U.S. poverty level. Net income—gross income minus certain deductions—must be equal to or below 100 percent of the poverty level. Households containing persons age 60 years or older or disabled persons need not meet the gross income eligibility criteria, but must meet the net income criteria.

Deductions allowed in determining countable income depend upon whether the household contains disabled or elderly persons. If it does not contain such persons, deductions for 1984 included:

- an inflation-indexed standard deduction of \$95 per month (higher for Alaska, Hawaii, the Virgin Islands, and Guam);
- 18 percent of all earned income;
- up to \$134 per month of the actual costs of child and/or dependent care that is necessary; and
- monthly shelter costs in excess of 50 percent of household income after other income deductions are applied. (The shelter deduction alone or in combination with the dependent care deduction shall not exceed the \$134 monthly limit on the deduction for dependent care costs. This deduction is higher for Alaska, Hawaii, and Guam, and lower for the Virgin Islands).<sup>6</sup>

Households containing elderly or disabled persons are allowed the same deductions, except (1) the excess shelter cost deduction is unlimited and (2) monthly medical expenses above \$35 are disregarded.

In addition to income limits, households may not have liquid assets valued at more than \$1,500, or \$3,000 in the case of households of two or more with an elderly member. Liquid assets do not include business assets, the value of a residence, personal belongings, or the fair market value (up to \$4,500) of a nonbusiness vehicle.

## Benefits

Food coupons are provided to eligible households, based on countable income and the applicable "thrifty food plan"—the cost of food in a particular state or area required to feed a family of four, adjusted for household size. (The "thrifty food plan" is higher for Alaska, Hawaii, the Virgin Islands, and Guam.) On the premise that a Food Stamp household spends 30 percent of its disposable income for food, a household's Food Stamp benefit generally equals the amount by which the Thrifty Food Plan exceeds about 30 percent of its countable income. (The offset is 12.6 percent for each dollar of SSI income and 28.5 percent for each dollar of AFDC income.) In 1984, the average monthly Food Stamp benefit was about \$43 per person.

Food Stamp coupons must be used in authorized retail food and other stores to buy food products intended for home consumption under a

<sup>6</sup>Effective May 1986, the dependent care and excess shelter deductions were separated and changed.

plan reviewed and approved annually by the Department. Such items as laundry or household supplies, pet food, cigarettes, and alcoholic beverages are not authorized purchases. Coupons can be used in Alaska to buy certain fishing and hunting supplies, and controls are placed on Food Stamp benefits in the Northern Mariana Islands to encourage the production and purchase of local commodities.

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### Funding Arrangements

Federal funds for the Food Stamp Program are open-ended. The federal government pays 100 percent of all Food Stamp benefit costs and 50 percent of most administrative costs.

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### Nutrition Assistance Program

Puerto Rico's Nutrition Assistance Program is a block grant through which cash is provided to needy households to purchase food. In addition, a small portion of the funds is used to stimulate agriculture, food production, and food distribution. The program is administered by Puerto Rico within funding and other limits established by the federal government and under a plan reviewed and approved annually by the U.S. Department of Agriculture.

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### Authority

The program was established by the Omnibus Budget Reconciliation Act of 1981 (Public Law 97-35)(7 U.S.C. 2028).

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### Eligibility Requirements

Puerto Rico has discretion over the eligibility requirements and benefit levels applicable to its program. Residence, citizenship, and alien requirements are similar to those for Food Stamps. However, there are some key differences.

Puerto Rico's maximum allowable monthly gross income limits, which varies depending upon household size, are \$449, \$558, and \$667, for families of two, three, and four, respectively. Resource limits under Puerto Rico's program are \$1,000 for households without persons over age 60 or disabled and \$3,000 for households with such persons. Households may disregard a family car, income-producing vehicles, and other vehicles with a total value below the maximum resource limits. Additionally, Puerto Rico's program contains no work requirement.

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### Benefits

Benefits are paid in cash and vary monthly. Because the program is capped, total monthly available funds are divided by total monthly

required funds to establish an adjustment factor for recipients' benefits. Monthly benefits are adjusted up or down depending on the previous month's factor.

The method of calculating Nutrition Assistance Program benefits is similar to that for the Food Stamp Program. The allowable disregards are deducted from gross income to determine countable income, and assistance is provided using adjusted Food Stamp tables from 1982.

Puerto Rico allows a standard deduction of \$40 per month plus 20 percent of earned income except in self-employment cases. Up to a combined maximum of \$40 per month for shelter, child care, and/or disabled care also may be deducted. In the case of households with elderly or disabled persons, shelter expenses in excess of 50 percent of monthly adjusted income may be deducted. In addition, up to \$100 per month of monthly medical expenses may be deducted for households with elderly or disabled persons.

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## Funding Arrangements

Federal funding for administrative and benefit costs of food assistance in Puerto Rico is provided under one grant. It was capped at \$825 million per year until Congress legislated annual increases to the authorized amount beginning in 1987. Funding ceilings were increased to about \$853, \$880, \$908, and \$937 million for fiscal years 1987, 1988, 1989, and 1990, respectively. Benefit costs are totally paid by the federal government under Puerto Rico's program. Administrative costs are shared on a 50/50 basis between the federal government and Puerto Rico.

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The federal funding and participation levels in the six federal programs for 1984-86 are shown in tables I.3 and I.4.



Appendix I  
Descriptions of Six Federal Welfare Programs  
Reviewed and Area Counterparts

**Table I.3: Federal Expenditures for Six Welfare Programs (1984-86)**

Dollars in millions

Program	Expenditures		
	1984	1985	1986
SSI	\$8,300	\$8,700	\$9,300
AFDC	8,600	9,000	9,300
Medicaid	20,100	22,700	24,700
Foster care (title IV-E only)	499	498	488
Child Support Enforcement	507	571	620
Food Stamps	11,579	11,701	11,698
<b>Totals</b>	<b>\$49,585</b>	<b>\$53,170</b>	<b>\$56,106</b>

**Table I.4: Participation in Six Welfare Programs (1984-86)**

Participants in thousands

Program	Participants		
	1984	1985	1986
SSI	4,029	4,138	4,153 <sup>a</sup>
AFDC	10,900	10,800	10,800 <sup>a</sup>
Medicaid	22,419	22,493	22,524 <sup>a</sup>
Foster care (title IV-E only)	101	100 <sup>a</sup>	102 <sup>a</sup>
Child Support Enforcement	8,000	8,401	<sup>b</sup>
Food Stamps	20,900	19,900	19,400

<sup>a</sup>Estimated.

<sup>b</sup>Not available.

# Descriptions of Income Taxes in the Four Areas

This appendix describes special U.S. tax provisions applicable to selected insular areas in 1987 and income tax systems in Puerto Rico, the Virgin Islands, Guam, and American Samoa in 1983 (the latest year for which tax data was available). Its purpose is to provide a frame of reference for analyzing the effects of fully extending federal income taxes to the four areas.

## Special U.S. Tax Provisions

U.S. corporations operating in insular areas, like other domestic corporations, are taxed on their worldwide income, including dividends, interest, and other income received from domestic and foreign subsidiaries. Corporations operating in insular areas, in addition to reducing their gross income by ordinary and necessary expenses of earning the income, may be entitled to other deductions and credits not available in the states. Most notably, such corporations' tax liability could be reduced by such credits as the section 936 credit and the foreign tax credit. The 936 credit is a dollar-for-dollar credit for taxes owed by qualifying corporations on income from Puerto Rico and U.S. "possessions." To qualify for the 936 credit, the corporation must derive at least 80 percent of its gross income for the 3-year period immediately preceding the taxable year from insular area sources and at least 75 percent from active trade or business conducted there.<sup>1</sup> The foreign tax credit is a dollar-for-dollar offset available for income taxes paid to foreign governments up to, but not exceeding, the U.S. income tax liability on the related foreign-source income.

U.S. corporations also may deduct from gross income all or a portion of dividends received from certain corporations. The deduction for dividends generally is 80 percent. After a phase-in period starting as early as 1987, a corporation generally will be entitled to a 100-, 90-, or 70-percent dividends-received deduction. Corporations claiming the section 936 tax credit can deduct 90 to 100 percent of dividends received.<sup>2</sup>

Furthermore, the tax Code includes special rules for the allocation of income from intangibles by corporations claiming the section 936 tax credit. As a general rule, income from intangibles is taxable to the U.S.

<sup>1</sup>In 1983, the trade or business criteria was 55 percent, in 1984, 60 percent, and in 1985 and 1986, 65 percent.

<sup>2</sup>Corporations affiliated with a section 936 corporation may receive a 100-percent deduction for dividends received from the section 936 corporation unless the payor was entitled to claim a dividends-paid deduction. In that event, the affiliated corporation could claim a deduction reduced to 90 percent of such dividends received. The percentage reduction is to be phased in at the rate of 1 percent a year for 10 years, beginning in 1987.

shareholders, although the corporation can "elect out" of the general rule under either a "cost-sharing" or a "50/50 profit split" option. These options provide a framework under which the subsidiary may claim some income from intangibles developed or purchased by its affiliated companies, while the U.S. parent corporation also recognizes some such income. The options apply to the products produced in whole or in part by the corporation.

Area corporations generally are treated as foreign corporations for U.S. tax purposes. Nonetheless, the rules calling for a 30-percent tax on foreign corporations' income do not apply to certain corporations in the Virgin Islands, Guam, and American Samoa.

Generally, area residents are excused from U.S. taxes on their area-source income. Residents of Puerto Rico and American Samoa pay U.S. taxes on U.S.-source income and income effectively connected with a U.S. trade or business. Residents of the Virgin Islands also pay taxes on U.S.-source income, but may satisfy their U.S. tax liability by paying taxes to the Virgin Islands. Puerto Rico residents also pay U.S. taxes on income from foreign areas. Taxpayers residing in Guam during any part of the tax year pay taxes to Guam or the U.S. depending on their residence on the last day of their tax year.

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## Area Income Taxes

Three of the area's income tax systems are very similar to the U.S. system. Puerto Rico's is significantly different.

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### Puerto Rico

Puerto Rico was given authority by the Revenue Act of 1918 to enact its own income tax system. In 1954, Puerto Rico adopted the system of taxation it used in 1983, generally patterned after the U.S. Internal Revenue Code of 1939.

With respect to personal income taxes, Puerto Rico taxed worldwide income, with allowances for certain adjustments, standard or itemized deductions, exemptions, and credits. While some adjustments, exemptions, deductions, and credits allowed by Puerto Rico were the same as those in the United States, some were different. For example:

- Puerto Rico allowed adjustments to gross income in 1983 only for business expenses, while the United States recognized moving expenses and other adjustments. But Puerto Rico allowed deductions for some items allowed as adjustments in the U.S. tax system.

- The United States allowed \$1,000 for each exemption in 1983, while Puerto Rico's exemptions differed by filing status—married couples and heads of households got \$2,000, and single taxpayers or married taxpayers living separately, \$800.
- Puerto Rico also generally allowed \$800 for children or \$1,000 for children in college, which it called credits, but which the United States treated as exemptions. The allowance is deducted from adjusted gross income in determining taxable income under both the Puerto Rican and U.S. tax systems.
- With respect to standard deductions, in 1983 the United States included \$1,700 to \$3,400 as a zero-bracket amount depending on the taxpayers' filing status. Puerto Rico, on the other hand, based its standard deductions on taxpayers' income, with the deduction ranging from 10 percent of income under \$10,000 to the greater of \$4,500 or 5 percent of income over \$75,000. In addition, Puerto Rico allowed taxpayers to claim special deductions along with their standard deduction.
- Puerto Rico allowed some deductions not allowed by the United States (such as for auto license fees) and some of the same itemized deductions but under different rules. (For example, Puerto Rico allowed a medical expenses deduction of 50 percent of all nonreimbursed costs over 3 percent of the taxpayer's adjusted gross income, while the United States allowed expenses over 5 percent for medical costs.)
- Puerto Rico allowed credit against tax liability for taxes paid to the United States, U.S. possessions, and foreign countries, while the United States allowed this and many other credits, such as the earned income credit. Puerto Rico, however, allowed deductions for some items recognized as credits on U.S. returns, such as child care expenses.

Finally, Puerto Rico's individual tax rates were higher than the U.S. rates. For tax year 1983, Puerto Rico's graduated individual tax rate ranged from 10.26 to 67.55 percent;<sup>3</sup> the U.S. rate ranged from 11 to 50 percent.<sup>4</sup>

U.S. citizens who did not reside in Puerto Rico were taxed on Puerto Rico-source income only and allowed the same deductions and credits as residents. Generally, individuals or businesses paying fixed or determined periodic amounts—such as dividends, interest, rent, and wages or salaries—from Puerto Rican sources to nonresident U.S. citizens were required to withhold 20 percent of these payments. To the extent this

<sup>3</sup>The maximum tax rate was reduced to 50 percent effective January 1, 1986.

<sup>4</sup>The maximum U.S. tax rate has been reduced to 38.5 percent for 1987 and 28 percent in 1988.

withholding exceeded the taxpayers' actual tax liability, the U.S. citizen had to file a Puerto Rico tax return for reimbursement.

Nonresident aliens also were subject to Puerto Rico income taxes at the same rates applied to residents. Deductions were permitted only when connected with Puerto Rico-source income, and no personal exemptions or credits were allowed. Those not engaged in a trade or business were taxed at 29 percent of gross income up to \$22,200 and at the same rates as residents above that amount. Any periodic income was subject to 29-percent withholding at the source.

With respect to corporate taxes, in 1983 Puerto Rico taxed all Puerto Rican-source income earned by U.S. and other foreign corporations and partnerships, and all worldwide income of Puerto Rican corporations and partnerships. The corporations could claim various deductions connected with earning income, including flexible depreciation. Flexible depreciation was allowed on property used in agricultural, construction, manufacturing, hotel, or shipping business, that could be depreciated without regard to useful life, subject to the restriction that flexible depreciation could not exceed 50 percent of the net profit determined without the deduction. This feature was not available in the federal income tax system. For tax year 1983, corporate tax rates were graduated from 22 to 45 percent, as opposed to rates from 16 to 46 percent in the United States.

Foreign and U.S. corporations engaged in trade or business in Puerto Rico were allowed deductions to the extent the deductions were connected with income from Puerto Rico sources. The tax rates were the same as those for Puerto Rico corporations. Such corporations not engaged in trade or business in Puerto Rico were subject to a flat tax of 29 percent of Puerto Rico-source income withheld at the source. Income from dividends of corporation and partnership profits from businesses engaged only in the operation of hotels, manufacturing, shipping, or industrial development generally were taxed at 10 percent ("tollgate tax"). Dividends from other entities were subject to a 25-percent tax.

Certain corporations doing business in Puerto Rico could qualify for substantial income tax exemptions under Puerto Rican law. Puerto Rico's incentives under its Industrial Incentives Act of 1978 include partial exemptions from income taxes (up to 90 percent of industrial development income) as well as other benefits, such as property tax exemptions. To qualify, corporations had to produce specified articles or provide specified services on a commercial scale. Exemptions were available

from 10 to 25 years, depending on the location of the corporation, with varying exemption ranges—90 percent for years 1-5, and 75, 65, 55, and 50 percent for year 6-10, 11-15, 16-20, and 21-25, respectively. Exemptions of up to 100 percent of income, provided under past legislation, were still in effect for some companies as well.

## Other Areas' Tax Systems

In 1983, the Virgin Islands, Guam, and American Samoa income tax systems were much like the U.S. system. By federal law, the Virgin Islands and Guam had to implement systems exactly as set forth in the U.S. tax Code—referred to as “mirroring” the Code. Essentially, wherever “United States” appeared in the Code, the name of the area was substituted. Taxpayers used the same forms (1040, 1120, etc.) in the Virgin Islands and Guam as in the states.

American Samoa's system was required by Samoan law to essentially “mirror” the Code, and U.S. tax forms or similar local forms were used. Nonetheless, taxpayers did not satisfy their obligation to file with the United States by filing with American Samoa. They paid taxes to the United States on U.S.-source income only, and paid taxes to American Samoa on Samoan-source income. But they received credit against their American Samoa tax liability for taxes paid to the United States.

## Virgin Islands

The Virgin Islands was required to “mirror” the Code—it had to operate an income tax system that followed the Code precisely. Accordingly, for the purpose of the Virgin Islands income tax generally “resident” meant a resident of the Virgin Islands; “domestic corporation,” a corporation chartered in the Virgin Islands; and “foreign residents and corporations,” all others including U.S. residents and corporations.

The U.S. tax Code provided exceptions to the general requirement that taxes in the Virgin Islands had to reflect U.S. income tax rules. For example, under the Virgin Islands “mirror” of U.S. taxation, income not connected with Virgin Islands business would be subject to a flat 30-percent tax for both nonresident aliens and foreign corporations. But the U.S. Code specifically reduced the flat rate for U.S. residents and corporations to 10 percent.

In addition, while not extending section 936 credits to the Virgin Islands, the Code allowed the Virgin Islands to exempt from income taxes U.S. and Virgin Islands corporations that derived at least 80 percent of their



gross income from Virgin Island sources and 65 percent from active trade or business conducted in the Virgin Islands.

Income tax rebates up to 90 percent, along with other benefits, were provided to qualifying corporations under the Virgin Islands' Industrial Incentives Program—established to promote economic development in the area. The program operating in 1983 was established in 1975 to promote the growth, development, and diversification of the economy; develop human and economic resources; create employment opportunities; promote capital formation; and preserve the environment. To qualify, a corporation had to meet investment, employment, and other criteria. Benefits, including the income tax exemptions, were available for 10 years, but could be extended to 20 years if benefits were decreased on a sliding scale down to 50 percent or extended for up to an additional 10 years for corporations locating in economically depressed areas.

The Virgin Islands was given authority by the U.S. Congress to impose a 10-percent income surtax, but the director of the Virgin Islands Bureau of Internal Revenue told us the areas had never opted to impose one.

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## Guam

Like the Virgin Islands, Guam was required to “mirror” the Code—it had to operate an income tax system that followed the Code precisely. The U.S. Code allowed some differences, however, between the U.S. and Guam systems. For example, the Code simplified treatment of U.S. citizens in Guam by allowing them to pay taxes to Guam or the United States depending on where they lived on the last day of their tax year. U.S.-source income was considered domestic for Guam income tax purposes. Full credit was allowed for taxes paid to the United States, without regard to the foreign tax credit limitation, and taxes withheld by the United States could be claimed on the Guam return.

The United States forwarded to Guam's treasury monies withheld from federal employees who were residents of Guam, including military personnel based in Guam. This was a significant personal income tax revenue source to Guam, mostly due to the significant U.S. military presence in the area. The United States also withheld tax on pension payments to retired military and civil service employees who reside in Guam and on compensation paid to Guam residents in the U.S. armed services.

Just as it treated U.S. citizens as residents, Guam generally treated U.S. corporations as domestic for purpose of taxation of income not connected with a U.S. business. A Guam corporation was not foreign to the United States if less than 25 percent of its stock was owned directly or indirectly by foreign persons and the source of at least 20 percent of its gross income was Guam.

Like Puerto Rico and the Virgin Islands, Guam also had an incentives program through which benefits were provided to businesses to encourage investment. Corporations organized in Guam or the U.S. could qualify for rebates for up to 75 percent of their Guam income taxes. To qualify, a corporation had to meet minimum investment and certain other requirements, such as increasing employment, replacing imports, or creating needed facilities. The rebates could be allowed for up to 10 years and could be renewed.

Guam was given authority by the U.S. Congress to impose a 10-percent surtax, but the director of Guam's Department of Revenue and Taxation told us it never had done so.

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## American Samoa

In 1963, the American Samoan legislature adopted the U.S. Internal Revenue Code as its own tax system, but amended the Code to adapt it to local needs. While the American Samoan individual income tax rules and rates in 1983 were basically the same as in the United States, there were some differences that arose from American Samoa's amendments and adjustments to its code. For example, American Samoa deleted the earned income tax credit provision contained in the Code and imposed a minimum tax of 2 percent of a filer's adjusted gross income. The acting manager of American Samoa's Tax Office told us the credit was repealed because it was too expensive. Moreover, American Samoa exempted the income of certain tuna boat workers.

Likewise, the American Samoa corporate income tax basically "mirrored" the U.S. tax Code, for the most part taxing corporations in the same way and at the same rates as the United States. Corporations doing business in American Samoa, however, could qualify for area tax exemptions. American Samoa provided tax incentives to corporations doing business there, allowing the governor to grant full or partial tax exemptions to corporations for up to 10 years. To qualify, a company had to attempt to employ residents of American Samoa to the extent of at least 75 percent of its total work force.

# Cost-Estimating Methodology for Extending Six Welfare Programs to the Four Areas

This appendix describes our methodology for estimating the costs of extending the SSI, AFDC, Medicaid, foster care, Child Support Enforcement, and Food Stamp programs to Puerto Rico, the Virgin Islands, Guam, and American Samoa on the same basis as the programs operate in the 50 states and the District of Columbia. The cost of extending these programs will be affected primarily by their designs as mandated by federal law and, where authorized, as initiated and controlled by the areas. In addition to American Samoa's having five of the six programs for the first time, fully extending the programs would have the effect of:

- Replacing existing adult assistance programs with SSI in Puerto Rico, the Virgin Islands, and Guam, thereby (1) increasing the number of eligible persons by replacing area-established eligibility criteria with uniform, federally established criteria; (2) increasing benefit payments by replacing area benefit levels with uniform, higher federal benefits; (3) replacing the current fixed 75-percent adult assistance federal-sharing rate with SSI's 100-percent federal-funding rate; and (4) eliminating the federal financial ceiling currently applicable to areas' combined adult assistance, AFDC, and title IV-E foster care expenditures.
- Eliminating the federal funding restrictions on AFDC in Puerto Rico, the Virgin Islands, and Guam by (1) converting the financing, which is currently capped along with adult assistance and title IV-E foster care expenditures, into an open-ended authorization for appropriations, and (2) providing federal cost-sharing at Medicaid rates, which are based on per capita income, instead of the current 75-percent rate.
- Applying the same rules to the four areas' Medicaid programs as are applied to state programs, including (1) generally limiting incomes of "medically needy" beneficiaries to 133 1/3 percent of the applicable AFDC payment standard, instead of applying the less restrictive income requirements currently in place; (2) establishing federal sharing rates for Medicaid expenditures using the same formulas that apply to states, instead of applying the current 50-percent fixed federal rate; and (3) eliminating the current funding ceiling. In addition, the "freedom of choice" Medicaid provision, which allows beneficiaries to choose their medical service providers, would be available to the areas. Areas historically have been waived from this provision, which was required for all states until enactment of TEFRA in 1982.
- Removing the federal funding ceiling on areas' title IV-E foster care programs by (1) converting federal financing to an open-ended appropriation authorization and (2) reimbursing program costs at state-like Medicaid rates instead of the current fixed rate.
- Reestablishing in Puerto Rico the Food Stamp Program, which was replaced by the Nutrition Assistance Block Grant Program in 1982,

thereby (1) removing the federal funding ceiling, (2) providing coupons instead of cash, and (3) applying eligibility criteria and benefit levels established by federal rules in place of those set by Puerto Rico.

Changes anticipated by area policy-making officials reflect their overall perspectives on (1) the adequacy of existing programs and the need for program changes to better meet residents' needs, (2) relevant economic conditions, (3) area budget constraints, and (4) political philosophies. For example, area budget conditions could affect the availability of funds for sharing purposes and directly affect the AFDC benefit levels in some areas, in turn influencing program participation and program costs.

We assumed all areas would participate in all programs, despite indications that most American Samoa officials did not want AFDC, foster care, Child Support Enforcement, or Food Stamps, and wanted Medicaid only in its present form. Additionally, while most officials favored SSI, the governor did not see a need for it. Puerto Rico officials also indicated that Puerto Rico would not participate in the title IV-E foster care program. Our intention in developing the estimates was to provide information on the probable costs if the six programs were fully extended to the four areas as they currently operate in the 50 states and the District of Columbia.

Generally, our estimates were based on 1984 data or, where these were unavailable, earlier data projected to 1984, and reflect the views of insular area officials at the time of our fieldwork.

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## Data Limitations

Our cost estimates were based on available data. Some Census Bureau data were available, but the type and amount varied by area. For example, population data by age, income, and marital status—key information for determining SSI program eligibility and benefits—were available for Puerto Rico and the Virgin Islands, but only partly available for the other areas, causing us to make some assumptions in developing our estimates. Additionally, we could not consider the effect of clients' resources in determining eligibility because we could identify no useful client resource data—a key eligibility factor for the SSI, AFDC, and Food Stamp programs. Similarly, because the data we identified on disability and blindness in the areas was of little value in determining program eligibility, we assumed the ratios of blind or disabled program participants to aged participants in the areas were the same as in the states.

In addition, census information on area population characteristics, other than gross projections of the total population, is outdated. The latest data were generated during the 1980 census and reflect 1979 characteristics. Unlike in the states, census income data for the insular areas are not updated through Current Population Surveys.<sup>1</sup> With the exception of our SSI cost estimate, whenever 1980 census data were used to arrive at an estimate, we applied the areas' gross population projections to inflate the data to reflect 1984 circumstances. For our SSI estimate, we used the changes in nationwide SSI participation in the states.

Only limited data were available in the areas as well. Program data available in Puerto Rico, the Virgin Islands, and Guam was of limited usefulness in estimating program costs because current program data do not necessarily indicate participation under extended programs. Moreover, American Samoa has only Medicaid program data. We did use information available from insular area population surveys, ad hoc studies, and other programs.

## Cost-Estimating Methodology by Program and Area

Because the type and amount of data for each area and program differed, as did the circumstances of each area, the cost-estimating methodology varied by program, and often by area. In addition, depending on the availability of data different assumptions were sometimes applied. Our estimating framework was:

- Total program cost = Total benefits +  
administrative cost.
- Total benefit cost = Number of program participants x  
benefits per participant (or case).
- Total administrative cost = Training +  
general administrative +  
other administrative costs.
- Federal share of program costs = (Total benefit costs x  
applicable federal financial participation rates) +  
(administrative costs x  
applicable federal financial participation rates).
- Area share of program costs = Total program cost -  
federal share of program cost.

<sup>1</sup>Current Population Surveys are Department of Labor-financed surveys carried out by the Census Bureau to update population information.

- Change in total program cost = Estimated program cost – current program cost.
- Change in federal share of program cost = Estimated federal program cost – current federal cost.
- Change in area share of program cost = Estimated area cost – current area cost.

## Supplemental Security Income

Estimating the cost of extending SSI entailed estimating the number of additional program participants, estimating and applying higher federally established SSI benefits for existing and new participants, and applying the federal sharing rate of 100 percent for program benefits, with no funding ceiling. Available information needed to estimate the cost of extending SSI varied significantly among the areas. Consequently, we used somewhat different cost-estimating methods, although Puerto Rico and the Virgin Islands were treated similarly. The methodology used to estimate administrative costs was the same for all of the areas.

We used 1980 census data to estimate the number of area persons over age 65, by marital status,<sup>2</sup> with incomes below the maximum SSI payment level plus a \$240 income disregard.<sup>3</sup> We assumed that the percentage of these income-eligible persons who would receive SSI benefits would be the same as the corresponding percentage in the United States (43 percent) based on actual numbers of SSI aged recipients.<sup>4</sup> Because of a lack of income data on blind and disabled persons, we estimated the numbers of such persons who would receive SSI benefits in the areas by assuming that the ratios of blind and disabled recipients in the areas would be the same as the ratios of such recipients in the United States. We then projected the numbers of estimated recipients to 1984 using the respective changes in the same three categories of SSI recipients in the United States.<sup>5</sup>

<sup>2</sup>Married men were assumed to have wives 5 years younger based on 1980 census data for persons of Spanish origin over age 65.

<sup>3</sup>We used the general disregard because less than 2 percent of aged SSI recipients have earned income.

<sup>4</sup>We grouped blind and disabled SSI recipients over age 65 with aged SSI recipients.

<sup>5</sup>This projection resulted in an estimate that disabled recipients under age 65 would represent 48 percent of all area SSI recipients. Under Puerto Rico's 1984 assistance program, such disabled persons accounted for 56 percent of all recipients. To the extent that Puerto Rico has a higher incidence of disability than the United States, our program cost estimate may be understated.



Benefits for aged recipients initially were set equal to the difference between their incomes from the 1980 census and the maximum SSI payment standard.<sup>6</sup> To estimate blind and disabled benefits, we assumed that the ratios of the average area blind and disabled benefit levels to our estimated average aged benefit level would be the same as the corresponding ratios for actual SSI levels in the United States in 1979. All benefit levels were projected to 1984 using the respective changes in average SSI levels for the three groups of recipients in the United States. Total estimated SSI benefits<sup>7</sup> for Puerto Rico in 1984 were obtained by multiplying the resulting benefit levels by the appropriate estimated numbers of recipients.

The changes in federal and area costs were calculated by comparing existing adult assistance costs with total estimated SSI costs. Because SSI is 100-percent federally funded, the federal cost would rise by an amount equal to program increases plus existing program costs. Area costs would decrease to zero, resulting in reduced costs equal to their current share of adult assistance costs.

#### Guam and American Samoa

Census data on Guam and American Samoa were significantly less detailed than data available on Puerto Rico and the Virgin Islands. For example, data were not available on the marital status of aged persons by 5-year increments. For this reason, and considering that Guam's and American Samoa's economic, social, and population<sup>8</sup> characteristics are similar to those in the Northern Mariana Islands (a remote insular area in the Pacific that participates in the SSI program), we based our estimates on actual SSI experience in the Northern Mariana Islands. Assuming the same average benefit levels as in the Northern Mariana Islands and adjusting for differences between that area and each of the other two areas in income among the aged and in overall population growth from 1979 to 1984, we estimated the number of SSI recipients and total benefits for 1984 in Guam and American Samoa.

<sup>6</sup>We assumed that persons with income were distributed evenly within income ranges.

<sup>7</sup>Estimated benefits were reduced for persons living in Medicaid-approved facilities or with persons providing noncash support, such as room and board, by assuming that the same percentage of estimated recipients would fall in these categories as fell in them in the United States in 1984—5.2 and 5.6 percent, respectively.

<sup>8</sup>We used civilian population for Guam because of the large number of U.S. active duty military personnel on the island, most of whom would not qualify for SSI benefits.

We calculated the change in federal and Guam costs the same way we did for Puerto Rico and the Virgin Islands—federal costs would increase by the total program costs and Guam would save an amount equal to its current adult assistance program costs. With respect to American Samoa, only federal costs were affected because the area has no adult assistance program.

SSI administrative costs were estimated by means of a methodology used by HHS's Office of Financial Resources. The estimate reflects (1) the cost of determining initial eligibility for new participants<sup>9</sup> from the average cost per case in all states and areas plus (2) recurring costs for existing participants related to periodic redetermination of eligibility and routine case maintenance.

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## Aid to Families With Dependent Children

Estimated costs of fully extending AFDC to the areas entailed determining the number of additional participants expected under the higher eligibility/benefit levels envisioned by area policy-making officials, calculating the benefits for current and new participants, applying higher federal sharing rates for program costs on an open-ended appropriation authorization basis, and adjusting costs for offsets expected through the areas' Child Support Enforcement programs. Different methods were used to estimate AFDC costs among the areas, primarily because the type and extent of data available for the areas varied.

The methodology for estimating AFDC administrative costs was similar for each area except American Samoa. For Puerto Rico, the Virgin Islands, and Guam, we multiplied each area's average cost of administration per participant in 1984 by the total estimated number of program participants under the prospective program changes. For American Samoa, we used Guam's average administration cost per participant, and multiplied it by the estimated number of American Samoa participants. The administrative costs for all area were split on a 50/50 basis between the area and federal government as are most administrative costs for the states.

## Puerto Rico

We used census data on Puerto Rican family characteristics, including household composition, marital status, family size, age, and income.

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<sup>9</sup>In accordance with HHS's suggestion, we assumed that persons who participated in the adult assistance programs would automatically be eligible for SSI, thus eliminating this group's cost associated with initial SSI eligibility determination.

With this data, we estimated the number of single-parent families that would have received AFDC in 1979 under the proposed higher payment standard,<sup>10</sup> taking reported income<sup>11</sup> and family size into account. We obtained a 1982 HHS study of actual 1979 AFDC recipient characteristics, from which we estimated the proportion of cases at the existing payment standard that were single-parent families. Assuming the same proportion would hold at the higher standard and accounting for different family sizes among cases with no adult, one adult, and two adults present, we estimated the total number of families and children that would have received AFDC in 1979 under the new standard. We projected these numbers to 1984 assuming that Puerto Rico's overall population increase from 1979 to 1984 applied equally to all subgroups.

To estimate the area's 1984 benefit costs under the new standard, we added the average 1984 AFDC benefit per actual recipient in Puerto Rico to the full increase in maximum benefits (the difference between the existing and new standards) and multiplied the result by the number of actual recipients in 1984. To this amount, we added the cost of new recipients under the higher payment standard, assuming the same proportional increase in the number of recipients as we estimated for 1979 and assuming that new recipients' incomes would be halfway between the two payment standards. To estimate the federal and area cost, we applied an 83-percent reimbursement rate—the maximum allowable—assuming Puerto Rico would opt to use the Medicaid reimbursement rate that would be applicable under fully extended treatment. We then subtracted actual 1984 AFDC costs from estimated costs under the fully extended program to calculate the federal and area cost changes.

## Virgin Islands

We used census income data from 1979 to estimate the number of Virgin Islands families below the existing AFDC payment standard. We compared this with the number of families<sup>12</sup> that actually received AFDC in 1979, as reported in the 1982 HHS study. Based on the comparison, we

<sup>10</sup>Puerto Rico officials told us they would raise their payment standard from 50 to 100 percent of the need standard, which would remain unchanged.

<sup>11</sup>No adjustments for income disregards were made because, according to Puerto Rico officials, most AFDC recipients have no income other than AFDC, as is the case in the United States according to the March 1986 House Ways and Means Committee print, "Background Material and Data on Programs Within the Jurisdiction of the Committee on Ways and Means."

<sup>12</sup>We assumed that the numbers of families with income were evenly distributed within income ranges.

estimated that about 85 percent of the families who met the income criterion (some of who may not have been categorically eligible) had actually received AFDC benefits.

Assuming this ratio would hold for our estimated number of families with incomes below the proposed higher payment standard,<sup>13</sup> we obtained an estimated number of persons who would have received benefits in 1979 under higher standard. We compared this number to the number of actual 1979 AFDC recipients under the existing standard. The resulting proportion was multiplied by the number of actual AFDC recipients in 1984 to produce an estimate of 1984 AFDC recipients under the new payment standard.

To the cost change we applied the Medicaid reimbursement rate that would be applicable under fully extended treatment—83 percent, the maximum allowable. AFDC 1984 costs were then subtracted from estimated costs to determine the Virgin Islands cost changes.

## Guam

To estimate the cost of fully extending AFDC to Guam, we used information provided by Guam from a 1984 study of the potential cost of extending the program there, with some significant adjustments. We expanded the potential number of eligibles to include mothers not in the labor force; assumed an average family size of 3.75, which was the size of the average AFDC Guam household in 1984; and used 100 percent of the proposed maximum need standard<sup>14</sup> envisioned by Guam officials as our income eligibility cutoff. To adjust for differences between our estimate and the study estimate with respect to including women in the labor force, we estimated recipient rates for females in and out of the labor force by using actual 1984 AFDC recipient data and data from the 1982 HHS study of 1979 AFDC recipient characteristics. Assuming these rates (17 percent for females in the labor force and 14 percent for females not in the labor force) would also apply at the higher need standard, we estimated the number of potential female recipients in Guam in 1984.

<sup>13</sup>Virgin Islands officials said they would double the need standard, but continue to pay at the reduced rate of 82 percent.

<sup>14</sup>In addition to the basic need standards, Guam also provides funds for special needs, up to a maximum amount. The proposed need standards developed by Guam were calculated taking special needs into account.

To estimate benefit costs for 1984 AFDC cases, we multiplied the number of families by the average 1984 AFDC payment plus the average benefit increase identified in Guam's 1984 study. The cost of benefits for the new recipients was estimated by multiplying the number of new recipients by the average benefit increase. To estimate federal and Guam costs, we applied the Medicaid reimbursement rate that would be applicable under fully extended treatment—83 percent. AFDC 1984 costs were subtracted from estimated costs to calculate the federal and area cost changes.

### American Samoa

Using census data on American Samoa's general population characteristics, we identified the number of male and female heads of households with no spouse present and children under age 18. Because of the lack of income data for these families, and in the absence of an existing AFDC program on which to base a recipient rate, we assumed that all of these families would be eligible for AFDC. We estimated total AFDC costs by taking data from a 1982 study of the cost of living in American Samoa; adjusting for inflation to 1984, using the U.S. Consumer Price Index; and assuming that 100 percent of this amount would be paid as AFDC benefits.<sup>16</sup> Federal and area costs were calculated using the maximum Medicaid sharing rate—83 percent.

Our estimate would be overstated to the extent participation is less than 100 percent. Conversely, it is understated to the extent that no costs are included for eligible children living with relatives other than the parent, for which no information was available.

Estimated AFDC costs for each area were adjusted to reflect offsets for collections through their Child Support Enforcement programs. As a condition of eligibility for AFDC, recipients must assign child support rights to the state or area. Collections from absent AFDC parents are used to offset AFDC costs, after first passing some collections to the caretaker (up to \$50 per month in 1984).

Estimated offsets for Puerto Rico, the Virgin Islands, and Guam, which already have Child Support Enforcement programs, were based on past experience. We multiplied the actual 1984 average AFDC collections per Child Support Enforcement case in each area by the estimated caseload

<sup>16</sup>We could not obtain a consensus on the level of AFDC benefits that would be paid in American Samoa because there is no current AFDC program and policymaking officials were reluctant to speculate on the amount of benefits that would be paid under full extension.

increase to estimate total AFDC collections. (See this appendix for our caseload methodology.) We identified the federal share by multiplying the estimated cases by the actual 1984 average federal share of total AFDC collections in each area. We identified each area share by multiplying the estimated collections by the actual 1984 average area share (including incentive payments) of total AFDC collections for each area.

For American Samoa, which does not have a Child Support Enforcement program, we estimated the AFDC offset using the same methodology, except that we applied Guam's actual 1984 AFDC average collections per case. We multiplied it by the estimated AFDC Child Support Enforcement caseload in American Samoa. We estimated the federal and American Samoa share by applying Guam's shares. We used Guam as a base for our estimate because of the demographic similarity between Guam and American Samoa.

## Medicaid

Our Medicaid estimates for Puerto Rico, the Virgin Islands, Guam, and American Samoa were based on the assumption that SSI and AFDC would be fully extended to all four areas as envisioned by area officials, thus making participants in these programs eligible for Medicaid services as "categorically needy" individuals. The number of "medically needy" individuals is predicated on the requirement that the four areas would be restricted by fully extended Medicaid income limitations—income of "medically needy" individuals' generally may not exceed 133-1/3 percent of the areas' maximum proposed AFDC payment standard for families of the same size. The number of "medically needy" individuals in Puerto Rico was estimated by using the 133-1/3 percent of the new AFDC payment standard as the maximum income for eligibility for different size families. Because of the lack of income information for the Virgin Islands, Guam, and American Samoa, we used the AFDC payment for the average family size to estimate the number of "medically needy" individuals and applied the 133-1/3 percent "medically needy" income eligibility criteria.

We assumed that, under fully extended Medicaid, areas' costs would approach states' costs, which are substantially higher. The changes in areas' costs would be affected by which of the numerous options they would adopt, not only with respect to who would be covered, but also by the types and extent of services allowed and payment levels. Because the exact design of areas' programs under fully extended Medicaid is unknown and in view of the areas' relatively low current average Medicaid costs, we estimated the areas' program cost using the average 1984



benefit cost per Medicaid recipient in West Virginia—the state with the lowest average cost. Specifically, we multiplied the estimated number of “categorically needy” SSI and AFDC individuals who received cash, “categorically needy” AFDC eligibles who did not receive cash, and “medically needy” AFDC eligibles by the average cost of services for each of these groups of Medicaid beneficiaries in West Virginia in 1984.

For “categorically needy” SSI persons who do not receive cash, we applied West Virginia’s 1984 average cost for SSI “medically needy” services—an option suggested by an official in HHS’ Medicaid Statistics Branch of the Actuary Office. He suggested that we use this approach if we did not want to assume such persons would be in institutions. Many “categorically needy” noncash persons in the states receive skilled nursing or intermediate care facility services—high-cost Medicaid benefits.

We do not believe assuming such persons would be in institutions in the area is reasonable, partly because the areas’ capacity to provide such services is questionable. For example, Virgin Islands officials told us there were no nursing homes in the area. While Puerto Rico has nursing homes, its reported Medicaid data provides no indication of its capacity to provide such services because it does not seek federal Medicaid reimbursement for required skilled nursing or optional intermediate care facility services. Also, we do not know whether the areas would elect to provide the full range of services to such people under fully extended Medicaid, especially in view of the potential high cost.

To the extent the area would provide Medicaid services to SSI “categorically needy” noncash recipients at a level that would approximate costs in West Virginia or the states, our estimates could be understated substantially. The average Medicaid cost for “categorically needy” noncash recipients is high—about \$6,800 per recipient in West Virginia in 1984, in contrast with about \$949 for “medically needy” SSI recipients. The estimates may be understated also because they do not include the cost of serving such mandatory groups as pregnant women during the last 4 months of pregnancy. Further, the number of participants would increase if the areas opted for higher AFDC payment standards or served groups not currently covered by AFDC.

Conversely, our estimates might be overstated. West Virginia currently offers certain services that the areas do not now provide and may not offer in the future, including podiatrist, psychologist, and inpatient psychiatric facility services. Also, the West Virginia cost reflects the average cost per recipient, but is applied to the number of area residents

estimated to be eligible to participate in a fully extended Medicaid program. Because some eligibles may not require or receive Medicaid services, the average cost per recipient is higher than the average cost per eligible. Additionally, the areas' average Medicaid costs would likely be decreased if the areas continue to provide Medicaid services through public health providers by continuing waivers to the "freedom of choice" provision.

The federal financial participation rates for each area were determined using per capita income data from the Bureau of Economic Analysis of the U.S. Department of Labor—the same source of information used to determine states' Medicaid rates. The rates reflect each area's per capita income as a ratio of the per capita income in all states.<sup>16</sup> The resulting sharing rates were 83 percent for all areas. Federal and area cost changes for program benefits were calculated by multiplying applicable sharing rates by estimated program costs and subtracting current program benefit costs.

Calculations of Medicaid administrative costs were based on the assumption that the average 1984 Medicaid administrative cost per recipient in Puerto Rico, the Virgin Islands, and Guam would be the same under fully extended Medicaid. These average costs were multiplied by the estimated number of Medicaid beneficiaries. For American Samoa, we used the average 1984 administrative costs in Guam. American Samoa was unable to provide us with Medicaid administrative costs for presumed Medicaid eligibles in 1984, and its current existing program is too different from fully extended Medicaid for comparison.

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## Foster Care

Foster care title IV-E benefit costs were calculated using the number of children from our AFDC recipient estimate. Only Guam provided information on the percentage of AFDC-eligible children that the government believes need foster care services. For the other areas, we assumed that the percentage of AFDC children in foster care in the United States in 1984 (1.4 percent) would have been the same in the areas. We applied this rate to the estimated number of AFDC children in each area to identify estimated numbers of AFDC children that would receive foster care.

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<sup>16</sup>The areas were excluded from the base for this calculation because applicable law requires the base to include only the continental United States (including Alaska) and Hawaii.

For Puerto Rico, the Virgin Islands, and Guam, we multiplied the result by the average monthly maintenance payments under the areas' programs for 1984. For American Samoa, we multiplied the estimated number of foster care cases by the payment that officials told us would be needed to cover the needs of foster care children. Our estimate is likely understated because Puerto Rico and Virgin Islands officials told us that foster care maintenance payments would increase under full extension, but did not specify by how much. Guam raised its maintenance payments in 1985.

With respect to titles IV-B and XX, we assumed that Puerto Rico and the Virgin Islands would continue to spend the same amount of title IV-B funds for foster care as they spent in 1984; the areas spent no title XX funds on foster care. Guam consolidated title IV-B along with two other programs under its title XX program and used some funds for foster care administrative purposes in 1984; we assumed the area would continue to spend the same amount of title XX funds for foster care administrative purposes. For American Samoa, we assumed that the total number of children who would receive foster care under title IV-B would be equal to (1) the actual average monthly number of children in foster care homes in 1984 paid with area funds plus (2) the average monthly number of child abuse and neglect cases handled by the area's Human Services clinic. From this, we subtracted the number of children we estimated would be eligible for title IV-E foster care. We assumed that the monthly foster care payment for these children would be equal to the monthly foster care payment used in our title IV-E estimate. We multiplied the average monthly payment by the estimated number of non-AFDC foster care children.

Federal and area shares of benefits were calculated for all four areas by applying the Medicaid reimbursement rate under fully extended treatment—83 percent.

Our method for estimating foster care administrative costs was the same for all four areas. We assumed the ratio of benefit costs to administrative costs in the areas would be the same as the ratio in the United States in 1984. We used our estimated benefit costs to project administrative costs, as well as total title IV-E costs, for each of the areas.

Administrative costs are shared at 50 percent, except training costs are shared at 75 percent. In 1984, the federal government paid 50.51 percent and states paid 49.49 percent of administrative and training costs.

We applied these rates to our estimated title IV-E foster care administrative and training costs in each area to estimate federal and area costs.

## Child Support Enforcement

Puerto Rico, the Virgin Islands, and Guam currently are treated like states for purposes of the Child Support Enforcement program. Our estimated Child Support Enforcement costs for each of these areas are equal to the actual 1984 costs, increased to reflect increases in AFDC participants under fully extended AFDC. Areas' AFDC caseload would increase because AFDC recipients must assign child support rights to the states or areas.

To estimate the increased Child Support Enforcement costs, we first divided the number of actual 1984 Child Support Enforcement cases for each area by AFDC participants in each area to determine the ratio of AFDC Child Support Enforcement cases to AFDC participants in each area. Applying this ratio to the additional AFDC participants in each area estimated under fully extended AFDC, we identified the new area Child Support Enforcement caseload. Multiplying each area's new caseload by each area's average cost per case (total Child Support Enforcement costs for each area divided by total cases for each area) yields each area's increased Child Support Enforcement costs. We estimated the federal share of each area's cost by multiplying the cost increase by the actual 1984 ratio, which was derived by dividing the 1984 federal share of Child Support Enforcement costs in each area by the total cost in each area. The areas' share of the cost increase was estimated the same way. Our Child Support Enforcement cost estimates for the areas do not reflect adjustments for any new AFDC participants that may have already received Child Support Enforcement services on a voluntary basis.

We based our Child Support Enforcement cost estimate for American Samoa on our estimate of the number of potential AFDC recipients there. Using a ratio from a recent GAO report<sup>17</sup> for which a limited sample of AFDC cases was analyzed to determine the proportion of AFDC children who are also included in Child Support Enforcement caseloads in the states, we estimated the number of AFDC children in American Samoa who we believe also will require Child Support Enforcement services. To this, we added the number of American Samoan divorce cases in which support was awarded, assuming all would need Child Support Enforcement services. After identifying the number of potential AFDC and non-

<sup>17</sup>Child Support. Need to Improve Efforts to Identify Fathers and Obtain Support (GAO/HRD-87-37).

AFDC cases, we calculated the cost of operating a Child Support Enforcement office to administer the program in American Samoa. Using information provided by HHS concerning the number and types of staff that would be needed to carry out a program of this size, and applying salary and operating cost information provided by American Samoa officials, we estimated the cost for 1984.

Federal and American Samoa shares were calculated by applying the 1984 federal reimbursement rates applicable to states—70 percent. The federal reimbursement rates were reduced to about 67 percent in 1986 as a result of the Balanced Budget and Emergency Deficit Control Act of 1985.

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## Food Stamp Program

Guam and the Virgin Islands currently are treated like states under the Food Stamp Program. Consequently, our cost estimates for these areas are equal to their actual 1984 Food Stamp Program costs less offsets (discussed below) for increased SSI and AFDC income. Our estimating methods for Puerto Rico and American Samoa follow.

### Puerto Rico

Our Food Stamp Program estimate for Puerto Rico is based on a Department of Agriculture estimate of the federal cost of implementing the program in Puerto Rico in fiscal year 1986. We adjusted the estimate to 1984 using the U.S. Consumer Price Index. We assumed that the number of persons eligible for Food Stamps, as well as the cost of administering the program, would be the same as in 1982 (adjusted for inflation) when Puerto Rico most recently participated in it. Costs of special projects that are unique to Puerto Rico's Nutrition Assistance Program were not included in our Food Stamp cost estimate.

### American Samoa

Using data from the 1980 census, we estimated the number of persons eligible for Food Stamp benefits from the number of persons whose income fell below the poverty level established by the Office of Management and Budget, adjusted to reflect the American Samoa population in 1984. (No adjustments were made for persons ineligible because they did not meet asset criteria, as no data were available on assets of potential American Samoan participants.) Average benefits for Food Stamp recipients were set at the average monthly Food Stamp benefit in Guam in 1984. We did this because of the demographic similarity between American Samoa and Guam. We multiplied the average benefits by our

estimated number of participants to estimate benefit costs. Program benefit costs would be 100-percent federally funded.

Our estimate of administrative costs in American Samoa was developed by multiplying Guam's average Food Stamp administrative cost per participant in 1984 by the estimated number of Food Stamp recipients in American Samoa. Administrative costs would be shared equally by the areas and the United States.

Estimates for each area were adjusted to reflect offsets resulting from increased SSI and AFDC income, which is counted in determining the amounts of recipients' Food Stamp benefits. According to Department of Agriculture officials, for each dollar of SSI and AFDC income received, 1984 Food Stamp benefits were reduced 12.6 and 28.5 percent, respectively. Assuming all SSI and AFDC recipients also receive Food Stamp benefits, we multiplied the applicable factors to the increase in SSI and AFDC benefits in each area and subtracted the result from their Food Stamp costs.



# Section 936 Tax Credit of the U.S. Internal Revenue Code: Effects of Its Repeal for Puerto Rico

## Purpose

A tax credit authorized by section 936 of the U.S. Code, allows certain U.S. companies to elect exemption from federal tax on income from Puerto Rico, the Virgin Islands, Guam, and American Samoa. Such tax provisions are intended to encourage U.S. corporations to engage in trade and business in these areas to promote industrial development and particularly employment-generating activities. This appendix (1) reviews the background of the section 936 tax credit and its influence on the Puerto Rican economy and (2) examines the alternatives that would be available to corporations were the credit repealed for Puerto Rico.

Our analysis in this appendix is limited to the credit as it affects Puerto Rico, as the greatest potential for revenue shifts under the prospective tax changes addressed in our study would come from U.S. corporations claiming the credit in that area. In tax year 1983, U.S. manufacturing corporations that operated in Puerto Rico received over 99 percent of section 936 tax benefits. Throughout the analysis, we make reference to various studies regarding Puerto Rico from which data and statistics are cited. They are identified in appendix VI.

The Department of the Treasury has suggested in its Fifth Report on the Operations and Effect of the Possessions Corporation System of Taxation that the credit provision affords tax benefits that are excessive in view of the number of jobs created by U.S. corporations in Puerto Rico. Treasury has estimated that repealing the provision there would generate tax revenues equal to amounts that U.S. corporations claimed as credits. Others have warned, however, that repealing the credit would adversely affect the Puerto Rican economy by aggravating its unemployment problem, likely would not produce large revenue gains for the U.S. Treasury, and could result in higher federal payments for Puerto Rican social programs.

Differing views about repealing the credit stem largely from differing assumptions about potential corporate responses to its repeal and differing assessments of the possible effects of unfavorable business responses on Puerto Rico's economy.

## Historical Background of the Section 936 Tax Credit

Tax exemption provisions in the Code for U.S. corporations operating in U.S. possessions were first enacted in 1921. These provisions were originally adopted primarily to reduce the tax disadvantage of U.S. companies operating in the Philippines and competing with foreign companies.<sup>1</sup> They were applied to other U.S. insular areas, exempting qualifying corporations from federal taxes on all income derived from these areas.

These federal tax provisions remained largely unchanged until recent years, with the enactment of the Tax Reform Act of 1976 and TEFRA in 1982.

The 1976 act left intact the credit on income derived by U.S. corporations from operations in possessions and exempted from taxation dividends repatriated by a qualifying corporation to its U.S. parent corporation. But, to prevent the avoidance of tax on income invested in foreign countries by such corporations, the Tax Reform Act eliminated the exemption for income derived outside the possessions. These changes were effected by removing these corporations from section 931 of the Code ("Income from Sources within Possessions of the United States") and placing them in a newly created section 936—"Puerto Rico and Possessions Tax Credit."

Amendments to section 936, as introduced by TEFRA in 1982, reflected concerns that corporations operating in the United States were shifting substantial income from such intangible assets as patents and trademarks to their affiliates in Puerto Rico to increase the tax savings provided under section 936.<sup>2</sup>

The 1982 act provided that, as a general rule, income from intangibles is taxable, but a qualifying corporation can "elect out" of the general rule if it shares the cost of developing the intangibles or splits the profit (income) from intangible assets equally with its parent company. The act also imposed stricter tests for these corporations to qualify for the section 936 tax credit.

In 1983, to qualify for the section 936 credit, a corporation had to derive 80 percent or more of gross income from a U.S. area, and 65 percent or

<sup>1</sup>The foreign concerns were substantially free from paying taxes to their governments on income they produced in U.S. areas.

<sup>2</sup>For example, a pharmaceutical company might develop a patentable drug in its U.S. laboratory and transfer the patent to its wholly owned subsidiary in one of the areas. The corporation would produce in whole or part the patented drug and claim the income from the patent as income subject to the credit.

more of gross income had to come from the active conduct of a trade or business there.<sup>3</sup> Like other U.S. corporations, qualifying corporations were subject to federal tax on their worldwide income. The credit, however, fully offsets the federal tax on income from a trade or business in U.S. possessions and from qualified investment income from these areas.

Qualifying corporations were usually organized as subsidiaries of U.S. parent companies. The advantage was that in 1983, U.S. parent corporations could offset dividends received from the area subsidiaries with a 100-percent dividends-received deduction, which freed the dividend income from federal tax.

In addition, certain qualifying corporations benefited from tax exemptions under Puerto Rican laws. Puerto Rican tax incentives for manufacturing and other specified business activities were first enacted in 1948, when Puerto Rico adopted its Industrial Incentives Act. Under this and similar subsequent acts, Puerto Rico granted partial exemptions from its income and other taxes to approved businesses for specified periods of time (generally 10 to 25 years). Section 936 corporations normally held an exemption contract from the Puerto Rican government.<sup>4</sup>

Moreover, Puerto Rico imposes a "tollgate tax" on dividends paid out of Puerto Rican-source earnings and profits to U.S. or foreign parent corporations that receive industrial incentive exemptions. The tollgate tax was assessed at a rate of 10 percent on dividends paid out of income derived from manufacturing, hotel, or shipping businesses, compared with 25 percent for most other businesses.

Essentially, section 936 tax credits in conjunction with the Puerto Rican tax incentives allow qualifying U.S. firms operating in Puerto Rico to pay reduced or no tax on their Puerto Rican business income (including

<sup>3</sup>Prior to the 1982 act, in addition to the 80-percent gross income test, only 50 percent of a corporation's gross income had to be from the active conduct of a trade or business in the areas. The act raised the requirement to 65 percent beginning in tax year 1985. Previously the requirement was perceived as vulnerable to abuse, since theoretically it allowed certain corporations to qualify for the tax benefits even when they derived up to half of their gross income from such passive investments as bank deposits in the areas. The Tax Reform Act of 1986 further raised this requirement to 75 percent.

<sup>4</sup>For nonexempt corporations, Puerto Rico in 1983 taxed all Puerto Rican-source income earned by U.S. and foreign corporations and taxed the worldwide income of all Puerto Rican corporations. Puerto Rican corporate tax rates range from 22 percent for taxable income under \$25,000 to 45 percent for taxable income in excess of \$300,000.

qualifying interest income and part of their income from intangibles).<sup>5</sup> Also, a U.S. parent company can repatriate the earnings of its Puerto Rico subsidiaries almost tax-free. Such tax-free repatriation was particularly attractive to high profit-margin operations that would have to pay the most taxes. Accordingly, these firms—mostly manufacturers—would gain the most tax savings from tax-free repatriation. It was also important to industries that invested large research and development expenditures that normally would be recouped only over a long period of time in the absence of tax incentives.

Tax-free repatriation of profits enhanced the effective rate of return on operations of qualifying corporations. It also reduced the average effective tax rates on the parent company's overall earnings. As a tool of economic development, these tax incentives effectively lowered the pretax rate of return required to generate an after-tax rate of return deemed necessary by management to justify investments, thereby allowing more investments to be made. The latter, in turn, spurred area employment and output.

Given federal and Puerto Rican tax incentives, most corporations claiming the credit engaged in manufacturing. Many were pharmaceutical companies, where operations involved high research and development spending. Others were in high-margin operations, producing hospital supplies and medical equipment. Still other corporations engaged in such industries as electronics and electrical equipment, food processing, and apparel. Most output of section 936 corporations was exported to the U.S. mainland or overseas.

## Section 936 Tax Credit and Puerto Rican Economic Development

Over the past 4 decades, the Puerto Rican economy has been transformed from one that was agricultural to one that is manufacturing and export-oriented. Because this development process has been complex, it is difficult to determine the extent to which Puerto Rico's economic progress is attributable to the section 936 tax credit and its antecedents. Tax incentives are but one of the factors influencing business investments. Others might include location and market considerations, as well as national and international conditions.

The importance of the tax exemption provisions, however, can be seen by comparing the Puerto Rican economy with those of its neighbors.

<sup>5</sup>These corporations paid in 1982, on average, only about 6 percent of their income in taxes to Puerto Rico.

Like its island counterparts in the Caribbean, Puerto Rico is small with few natural resources. Yet Puerto Rico's per capita gross national product is more than twice that of most of its neighbors. While manufacturing accounted for almost 60 percent of Puerto Rico's net income, it did not exceed 26 percent of that of any of the Central American countries, Jamaica, or the Dominican Republic. Like Puerto Rico, however, these countries trade heavily with the United States. Most also benefit from U.S. economic aid, and, more recently, the Caribbean Basin Initiative.<sup>6</sup> Also, the United States has a military presence in some of these countries. Yet only Puerto Rico has tax-free repatriation of profits to U.S. firms.

The federal tax benefits appear to have been critical to Puerto Rican industrial development to date. Nonetheless, the significance of the tax exemption provisions should not be overstated. Tax incentives do not operate in a vacuum; they can be strengthened or diluted by other economic factors. Over time, Puerto Rico's development experiences have demonstrated just such a case.

Puerto Rican economic development since 1950 can be roughly divided into two periods. During the 1950-72 period, there was a sustained rise in private investment in Puerto Rico resulting in a modern manufacturing sector with employment dominated by such labor-intensive industries as food, tobacco, apparel, stone, clay, and glass. During this period, manufacturing employment almost tripled, from 55,000 to 142,000. Gross national product (in 1972 dollars) grew at an average annual rate of 6 percent, and real per capita gross national product rose by an average annual rate of 5 percent.

Since 1973, however, Puerto Rico's economic progress has been slow. Private investment in plant and equipment as a percentage of gross national product fell steadily, from 10.3 percent in 1973 to 4.6 percent in 1983. In constant dollar terms, it actually declined in most years, so that in 1983 it was about 60 percent of the level of a decade earlier. Manufacturing employment has stagnated. (Nonetheless, there has been a shift from labor-intensive industries to high-technology ones, such as chemicals—in particular, pharmaceuticals—scientific instruments, electrical and electronic equipment, and machine industries.) In addition, real gross national product and real per capita gross national product

<sup>6</sup>This program offers trade and tax measures to aid Caribbean Basin economic development. It features duty-free access for certain products shipped into the U.S. market.

largely changed little, while the unemployment rate surged from 10-12 percent in the 1950-72 period to a high in 1985 of 23.5 percent.

Aside from the tax incentives, the rapid growth in the manufacturing sector during the first period gained impetus from Puerto Rican wages, which were relatively low compared with those on the U.S. mainland. Puerto Rico also had the advantage relative to low-wage foreign countries in that it was within the the U.S. tariff wall.

Likewise, in recent years more than tax incentives have affected Puerto Rico's industrial development. The decline in Puerto Rico's economic performance has been much affected by U.S. economic conditions (such as the recessions of 1974-75 and 1981-82). In addition, changes in Puerto Rico's competitive advantage have had an adverse impact. Specifically, the rise in Puerto Rico's wages (a result of the imposition of federal minimum wages), the lowering of U.S. trade barriers to foreign imports (a consequence of cuts in U.S. tariffs following multilateral trade talks), and the growth of industrial sites in the Far East (spurred by the technological development in newly industrialized countries) have significantly eroded Puerto Rico's labor cost, location, and market advantages. Facing such changes and shifts in market demand, it is not surprising that Puerto Rican corporations have moved away from labor-intensive industries to high-technology ones.

Meanwhile, in the United States, the reduction in the effective corporate tax rates of manufacturing industries (resulting from more liberal depreciation allowances under the accelerated cost recovery system and the investment tax credit) reduced the potential tax savings for corporations claiming section 936 tax credit.

In short, while tax exemptions have represented a significant benefit to qualifying corporations, their investment decisions have been affected by a host of economic conditions. In the future, while tax exemptions are likely to remain a major inducement for foreign investments in Puerto Rico, the impact of tax incentives on development is less than certain.



## U.S. Corporations Claiming Section 936 Tax Credit and the Puerto Rican Economy

U.S. corporations claiming section 936 tax credit can have diverse effects on the Puerto Rican economy. Directly, they create income and employment through their industrial operations. Indirectly, they generate income and employment through backward and forward linkages. Backward linkages refer to “upstream” industries that provide these corporations with such inputs as raw materials, intermediate goods, and services. Forward linkages relate to “downstream” industries that sell and distribute these corporations’ output.

In addition, economic activities undertaken by such corporations and related industries stimulate demand for other goods and services (such as wholesale and retail activities, finance, real estate, transportation, utilities, and others). In this way, they further stimulate employment and output in other industries in the private sector. Growth of the private sector, in turn, generates tax revenues and facilitates the expansion of public services.

The simultaneous growth of employment in manufacturing, services, and the public sector has been evident in Puerto Rico. A precise estimation of such “multiplier” effects, however, is difficult to render. In the United States, the multiplier effect of U.S. industries on employment, according to estimates of the U.S. Department of Commerce, is around 1.45. There is no reason why the multiplier effect for similar industries made up largely of U.S. firms in Puerto Rico should be significantly higher than that in the United States. Some moderate adjustment to account for the relatively more labor-intensive Puerto Rican economy, however, may be appropriate.

In addition to having a direct and indirect impact on the island’s output and employment, corporations qualifying for the 936 tax credit can contribute to the Puerto Rican economy through their financial resources. The financial assets these corporations hold provide a major source of capital for other corporations, which borrow for commercial and industrial purposes; for consumer mortgages; and for the government. The tax-exempt status of qualified investment income makes it advantageous for qualifying corporations to leave their financial assets in Puerto Rico, even though interest rates there are lower. Some observers argue that, were no qualified investment income available in Puerto Rico, it would have to secure capital from external sources and at higher cost.

According to the U.S. Department of the Treasury, 447 out of 554 qualifying corporations<sup>7</sup> in Puerto Rico in 1982 were engaged in manufacturing. Their total net income for the year amounted to about \$4.7 billion. Direct employment in these corporations was estimated to be around 81,250, representing 60 percent of 1982 Puerto Rican manufacturing employment or 11 percent of its total employment.

Pharmaceutical companies had the largest share (52 percent) of 1982 net income from qualifying corporations engaged in manufacturing. They accounted for 15 percent of the 1982 employment of corporations claiming the credit. Electric and electronic companies employed the largest number of workers, estimated at 26,065. They accounted for 19 percent of the net income, the second largest share.

The Treasury suggested that, since most of the manufactured output of these corporations was exported, the development of "downstream" industries stimulated by such corporations was less significant than otherwise might be the case. With regard to "upstream" industries, the Treasury recognized that locally owned electronics, metal products, and plastics industries were increasing their sales of materials to electronics corporations claiming the credit and that most apparel firms obtained their inputs from locally owned companies. Further, Treasury noted that a substantial service sector in Puerto Rico provides banking, transportation, and utilities to all manufacturing corporations claiming the credit. Nonetheless, Treasury did not offer in its Fifth Report estimates of secondary employment generated by such corporations.

Treasury noted that, at the end of 1983, corporations claiming the section 936 credit held approximately \$11 billion in Puerto Rican financial assets. Most of these funds were invested in bank deposits, repurchase agreements, mortgage securities, real estate loans, loans to other possession corporations, and Puerto Rican government obligations. Other observers suggested that the availability of qualified investment funds lowered the interest rate paid by commercial banks on section 936 funds. The Puerto Rico Government Development Bank estimated that the interest rate was lowered about 2 percentage points, saving the banks about \$120 million in interest costs in 1985.

<sup>7</sup>Treasury data indicate that 524 of 622 corporations qualifying for the credit in tax year 1983 were manufacturing firms. Data was not yet available on receipts or employment in 1983.

There was a consensus among observers that section 936 corporations have played a major role in the Puerto Rican economy. But there is disagreement on the economic impact were federal tax incentives benefiting these enterprises to be repealed.

## Effects of Repealing Section 936 Tax Credit for Puerto Rico

The effects on the Puerto Rican economy of repealing the section 936 tax credit would depend on corporate reactions. Other things being equal, the repeal would discourage new investment by U.S. corporations in Puerto Rico. Nonetheless, as previously noted, Puerto Rico's economic performance demonstrates that foreign investments on the island are affected by a host of economic factors, as well as tax provisions. To the extent that other economic considerations might favor Puerto Rico as a future investment site for U.S. corporations, U.S. investments in Puerto Rico could continue, even in the absence of the credit.<sup>8</sup>

As for such corporations currently operating in Puerto Rico, they would have at least four choices:

1. Remain in Puerto Rico as U.S. subsidiaries, but pay federal taxes on their Puerto Rican earnings.
2. Relocate to foreign areas (such as Ireland, Mexico, Hong Kong, Taiwan, and Singapore) that offer tax incentives, low wages, and other market advantages. Being foreign corporations, they would pay no federal taxes until they repatriated their earnings. Foreign tax credits would also reduce their U.S. tax liabilities.
3. Move back to the United States and pay U.S. federal income taxes.
4. Close.

Which options they would choose would depend on the decisions of individual firms and are difficult to predict precisely. It would be unrealistic, however, to assume that all such corporations would act similarly, given their various business operations. Key considerations bearing on corporate decisions would include the nature of the industry, requirements of operations, costs of relocation, and the availability and attractiveness of alternative foreign sites.

<sup>8</sup>For example, if protectionist measures were introduced in the United States to ward off foreign imports, Puerto Rico once again would enjoy its advantage over foreign countries in being within the U.S. tariff wall. In addition, a strong U.S. economy and/or other inducements Puerto Rico offers to foreign investors would attract capital investment to Puerto Rico.

In the short term, given that corporate decisions to relocate take time to make, it is unlikely there would be a rapid exodus of these corporations from Puerto Rico. Over the long term, however, after corporations had time to react to the prospective repeal of the credit, the corporate response probably would be mixed. Corporations with low and moderate levels of capital investment would be most likely to shift their operations to foreign sites, if it were advantageous for them to do so. Firms with substantial capital investments, however, would find it more difficult to relocate and would be inclined to stay in Puerto Rico.

Moreover, some firms that derived their income from investment in physical assets (plant and equipment, etc.) probably would reincorporate in foreign jurisdictions. Through reincorporation, these companies would continue to pay no federal income taxes until they repatriated their earnings. Firms that derived their income largely from intangibles, however, would be less likely to do this because they would be precluded from benefiting from such tax savings.

The Deficit Reduction Act of 1984 provides that in the case of an otherwise tax-free transfer of intangible property from a U.S. person to a foreign corporation, the transferor is treated as receiving payments over the useful life of the property on an annual basis. Such payments are deemed U.S.-source income. These tax provisions, which retain the U.S. taxing authority over income from an intangible even if transferred to a foreign corporation, would make it not worthwhile for corporations that derive the bulk of their income from intangibles to reincorporate or relocate elsewhere and would encourage them to stay in Puerto Rico or return to the U.S. mainland.

A detailed analysis of the industrial composition in 1984 of corporations claiming the section 936 credit in Puerto Rico would shed light on probable corporate responses to repealing the section 936 tax credit. What follow are some tentative observations.

1. The apparel industry in Puerto Rico was labor-intensive, requiring little capital investment. Because of Puerto Rico's wage rates, which are not competitive with low-wage areas in the Caribbean or the Far East, very few firms were expanding their operations on the island, despite the section 936 tax credit. Some were considering shifting their production to lower cost locations in Asia or the Caribbean. Repeal of the credit would hasten such departures, as low capital investments and available alternative sites would make relocations relatively easy. Few would

move back to the United States because of high labor costs on the U.S. mainland.

2. The electronic and electrical equipment industry was the most technologically dynamic and fastest growing segment of the manufacturing sector in Puerto Rico. The growth in U.S. and worldwide markets for electronics has boosted the development of the industry. The industry's major products were computing equipment, terminals, printers, and circuit boards, among others. A number of these firms having heavy fixed capital investments in Puerto Rico might continue their operations there regardless of the status of the credit. It is likely, however, that repealing it would curtail their expansion. Over the long term, those with lower capital investments might phase out their operations and relocate elsewhere, most likely, to newly industrialized countries in Asia or to Ireland, from which they could easily ship their products to the European markets.

3. The pharmaceutical industry in Puerto Rico typically either produced bulk pharmaceutical products or performed finishing operations on bulk products produced outside the area. Bulk products manufactured in Puerto Rico generally were exported to foreign affiliates for local finishing to satisfy "local content" requirements. The majority of products finished in Puerto Rico were sold on the U.S. mainland.

Virtually every major U.S. pharmaceutical manufacturer had operations in Puerto Rico. The area was an attractive production site for U.S. firms to serve the U.S. pharmaceutical market because of the tax benefits, absence of tariffs, and minimal federal regulatory complications associated with such activities.

Such production processes were the most highly capital-intensive among manufacturing industries in Puerto Rico. In view of the industry's strong profitability, the outlook for the industry was good. Repeal of the credit probably would curtail the expansion of the industry. Firms that have incurred high fixed investment are likely to stay. Current tax laws on intangible property incomes, as previously discussed, would provide few incentives for these corporations, which derived most of their income from intangibles (principally patents for drugs), to move overseas.

4. In the food processing industry in Puerto Rico, corporations claiming the credit were diverse. They manufactured a wide range of products, including soft drink concentrates, canned tuna and other food items,

powdered beverages, jam and jelly ingredients, and agricultural feedstock. Firms producing soft drink concentrates performed capital-intensive mixing operations. Most other food processing firms were fairly labor-intensive.

With repeal of the credit, the high-margin producers of soft drink concentrates probably would have little incentive to remain in Puerto Rico and would return to the U.S. mainland. Because of the relatively heavy capital investments of these firms, they probably would phase out their operations in Puerto Rico over a 3-or 4-year period. Likewise, canning and packaging processors would tend to shift their operations to the U.S. mainland, which has had substantial excess capacity. They likely would relocate over a year or 2 because of their low-capital investments.

5. In the hospital supply and medical instrument industry in Puerto Rico, corporations claiming the credit were largely subsidiaries of highly diversified health care firms in the United States. They manufactured a wide range of high-margin products. Production processes varied considerably—some were labor-intensive, others, capital-intensive. With repeal of the credit, the attractiveness of Puerto Rico as a production and investment site would be sharply diminished. Most likely, firms having low levels of fixed investment would phase out many of their operations and relocate to such low-cost sites as Mexico or elsewhere in the Caribbean. Firms having heavy capital investments gradually would decline over the long term.

6. The professional and scientific instrument industry in Puerto Rico manufactured such products as spectrometers, panel meters, thermostatic parts, and microfilm jackets, among others. Operations were moderately labor-intensive. The outlook of the industry was not good because of foreign competition in the U.S. market. Repeal of the credit would accelerate the decline. The low level of fixed investment in the industry would permit such corporations to relocate to Asia or elsewhere in the Caribbean without major financial losses.

To the extent that firms left Puerto Rico, the island's economy would contract, reducing output, employment, and availability of capital. All else being equal, such a situation could require higher federal payments to support Puerto Rico's social programs, as well as augmented federal budgetary assistance.

To the extent that firms returned to the United States or remained in Puerto Rico, overall Treasury receipts would grow only if the additional



tax revenues that resulted exceeded additional federal outlays needed to support Puerto Rico's social programs.

To the extent that corporations relocated overseas, Treasury receipts generally would be realized only when firms repatriated their earnings. Such receipts would be net of credits for taxes paid to overseas jurisdictions.

## Estimates of Probable Receipts From Puerto Rico to Treasury Upon Repeal of the Section 936 Tax Credit

The U.S. Treasury estimated from 1982 corporate tax return statistics that, because of the section 936 credit, about \$1.7 billion in tax revenues were foregone by the United States on earnings from corporations in Puerto Rico. Estimates by various private organizations were much smaller; in particular, the Institute for Research on the Economics of Taxation concluded that Treasury receipts generated by repealing the credit would be minimal.

The Treasury estimates were based on the assumption that, were the credit eliminated, most earnings of existing corporations claiming the credit would be taxed. Its argument was that, except for corporations that derive their income from investment in physical assets (plant and equipment, etc.), corporations claiming the credit that secured their income from intangible assets would have to pay federal income taxes on their earnings. This would be true whether they reincorporated in Puerto Rico or elsewhere or returned to the United States. About half of the 1982 earnings of corporations claiming the credit in Puerto Rico were from intangibles, and the other such corporations probably would remain in Puerto Rico if granted a wage credit.<sup>9</sup> Thus, the Treasury concluded that repealing the credit would bring into the Treasury an amount equivalent to tax savings realized by U.S. corporations on their incomes in that year. Tax savings were calculated by subtracting from tax credits claimed by such corporations the amount of depreciation allowances and investment tax credits due them if they paid income taxes on their earnings.

But the Institute for Research on the Economics of Taxation study maintained that, except for labor-intensive industries (in which the majority of these corporations were not engaged), a wage credit would not be a strong incentive for such corporations to continue to operate in Puerto Rico. In the event of the repeal, it argued, these corporations would be likely to relocate; few would return to the U.S. mainland. As a result,

<sup>9</sup>Treasury officials believe the current portion of earnings from intangibles is higher than 50 percent.

little tax revenue would be generated for the Treasury. On the contrary, corporate transfers out of Puerto Rico would exacerbate the island's unemployment situation, thereby requiring higher federal outlays for Puerto Rico's social assistance programs.

For the short term, the Treasury estimates might be valid, especially if the repeal were effected when corporations claiming the credit had little choice or time to relocate. Over the long term, however, the estimates may be overstated. This would be the case if such corporations gradually sought alternative tax-saving possibilities or simply halted their operations. As they did, Treasury receipts would be diminished.

While depicting the longer term adjustment process, the Institute for Research on the Economics of Taxation study ignored other factors that might induce such corporations to continue to operate in Puerto Rico. As a result, its estimates may be understated. The most plausible scenario would appear to be somewhere in between.

# Revenue-Estimating Methodology for Extending Federal Income Taxes to the Four Areas

This appendix describes our methodology for estimating changes in U.S. and areas' tax revenues from fully extending U.S. income taxes to the areas. Our estimates were for both 1983 tax revenues, assuming no change in business activity, and longer term tax revenues.

Personal and corporate income tax liability (the amount of taxes owed less any allowable credits) is derived the same in the four areas as in the United States. Gross income less allowable adjustments, exemptions, and deductions yields taxable income—the base figure to which tax rates are applied to compute tax liability.

To estimate the revenue effects of the prospective tax changes, we used aggregate tax data for each area, adjusting for differences in the tax systems. Our methodology was different for each area because each had a unique tax relationship with the United States, and the type and amount of information available from which to estimate tax revenue varied. All estimates were based on data for the 1983 tax year, the latest full-year federal tax data available.

## Short-Term Estimate

### Puerto Rico

Although Puerto Rico's income tax system is similar in some respects to the U.S. system, there are substantial differences between the two. Consequently, to estimate the revenue effects of fully extending U.S. taxes, we adjusted income and other tax-related data to ascertain tax liability for Puerto Rico. Where the area tax data were unavailable or were not comparable with U.S. tax data, we made various assumptions to reconcile the differences.

Using personal income tax data from Tabulation de la Cinta Planillas Cuadradas—a tabulation of relevant personal income tax data prepared by the Puerto Rico Department of Treasury—we identified the number of taxpayers by filing status and income range. Puerto Rico has only three filing categories—married, head-of-household, and single; it does not recognize married filing separately as a separate category, as does the U.S. tax system.<sup>1</sup>

<sup>1</sup> Our ultimate revenue estimate is understated to the extent that Puerto Rican taxpayers who would be classified as married, filing separately, fall into one of Puerto Rico's existing filing status categories. These individuals would pay higher rates than reflected in our estimate. Data were not available to identify the number of affected taxpayers.

Next, we estimated the deduction that would have been taken were Puerto Rican taxpayers taxed under the federal system. Because Puerto Rico's system is substantially different than the U.S. system with respect to itemized deductions, we applied U.S. experience to Puerto Rican taxpayers, assuming that the same percentage of Puerto Rican taxpayers, by filing status and income ranges, would take the same level of itemized deductions as their U.S. counterparts. We obtained information on U.S. taxpayers from the Individual Income Tax Returns, 1983: Tables Emphasizing Returns Filed, Sources of Income, Exemptions, Itemized Deductions, and Tax Computations, published by the Statistics of Income Division of the U.S. Internal Revenue Service. This publication has relevant 1983 U.S. personal income tax data by income bracket and filing status, adjusted gross incomes, salaries and wages, credits, and dependent information. We multiplied the number of Puerto Rican itemizers in each filing status and income bracket by the average excess itemized deduction—average U.S. itemized deduction amount less the zero-bracket amount—to estimate total excess itemized deductions.

Personal exemptions were then calculated by adding all filers, spouses, children, and other dependents by filing status and income ranges. Because the United States allows additional exemptions for the aged, we increased total exemptions by 8 percent—the number of persons aged 65 and over in Puerto Rico according to available 1980 census data—and allocated the exemptions among filing status and income range. We did not make an adjustment for blind persons due to the lack of available data and because the number of blind persons is presumably small; U.S. filers taking the exemption for blindness amounted to .3 percent of total filers in 1983.

To identify total taxable income by filing status and income range, we subtracted exemptions and excess itemized deductions from the adjusted gross income. We then divided total taxable income by the number of taxpayers in each filing status and income range to estimate the average taxable income. Applicable U.S. tax rates were multiplied by the number of filers in each status and income range to determine total taxes owed.

Adjustments were then made to account for credits that would be allowed by the United States, but not by Puerto Rico. Most notably, adjustments were made for the earned-income credit, which Puerto Rico does not recognize. Using the data provided by the Puerto Rico Department of Treasury, we identified the number of taxpayers in Puerto Rico with dependents and adjusted gross income below \$10,000, along with

the average amount of earned income (salaries and wages) and the average adjusted gross income. We then multiplied the corresponding earned-income credit that would have been provided under the U.S. Code by the number of qualified filers to identify total earned-income credit.<sup>2</sup>

To estimate adjustments for other tax credits, we assumed the percentage of filers and the amount of credits taken in Puerto Rico would be at the same level as in the United States, excluding earned income credit. After calculating the percentage of filers and the average amount of credits in the United States, using tax data provided by the U.S. Internal Revenue Service, we applied these factors to the total Puerto Rican filers. We subtracted these credits and the earned income credit from taxes owed to identify total personal income tax liability.

The Puerto Rico Planning Board, which accumulates statistics on Puerto Rico business, provided information on corporate income, which we tried to use in estimating corporate tax liability. However, this did not provide corporate taxable income, needed as a tax base before a rate could be applied. The Puerto Rico Department of Treasury's latest corporate income and tax data were for 1981, and officials were unable to provide income information for all Puerto Rican business.<sup>3</sup>

Accordingly, we used an alternative approach in developing a corporate tax estimate for Puerto Rico. Essentially, we summed estimates of taxes to be obtained from companies claiming section 936 credits and firms not claiming this credit.

To obtain estimated taxes from firms claiming the 936 credit, we used 1983 credit data (corporations with tax years beginning July 1982 through June 1983) from the U.S. Internal Revenue Service, similar data published in Treasury's Fifth Report on the Operations and Effect of the Possessions System of Taxation (1982), and data obtained from the Treasury official responsible for preparing the Fifth Report. As Treasury did for 1982 credits, we adjusted 1983 section 936 tax credits downward for tax-saving provisions (accelerated cost recovery system and investment tax credit) not available to firms electing to claim the

<sup>2</sup>Our estimate is overstated to the extent that we allowed earned-income credit for taxpayers with dependents who were not children. We could not distinguish between types of dependents by filing status and income range with the available income tax data.

<sup>3</sup>Data were available from the Puerto Rico Department of Treasury on taxes collected for tax year 1983, and on net earnings for corporations that received income tax exemptions, but not for other corporations.

benefits of section 936. We did not, however, adjust tax benefits downward for the foreign tax credit since (1) this credit would not be available were Puerto Rico taxed like a state and (2) we assumed that U.S. taxes would replace Puerto Rico income taxes. Like Treasury, we assumed no tax benefits for nonmanufacturing firms claiming the 936 credit.

About 24 percent of the corporations claiming 936 credits in 1983 had accounting periods beginning before the effective date of the TEFRA provisions on intangibles. We did not adjust their credits for the impact of TEFRA because the available data provided no basis to do so and Treasury officials provided no methodology for making this adjustment in their comments. To the extent that TEFRA caused the foregone U.S. income tax to decrease or increase, our estimated revenue changes would have been over- or understated.

To obtain estimated taxes from firms not claiming the section 936 credit, we used 1983 Puerto Rico tax collection data provided by the Puerto Rico Treasury Department and data on 1982 Puerto Rico tax collections from firms claiming the section 936 credit. Data on 1983 collections from section 936 companies were not available, but (1) total credits claimed were about the same in both years, (2) income was accordingly assumed to be about the same, and (3) corporate tax rates, which were nearly the same as U.S. rates, were not changed between 1982 and 1983. By deducting estimated collections of firms claiming section 936 from total collections, we obtained an estimate of collections from non-936 companies.

In this way, we estimated that firms electing section 936 would have yielded revenue of about \$1.913 billion in 1983. Firms not claiming the credit would have provided an estimated \$240 million. Thus, total revenue in 1983 from corporate taxes in Puerto Rico was estimated at about \$2.153 billion.

## Virgin Islands

Because the Virgin Islands "mirror" the U.S. tax Code, and taxpayers were taxed virtually identically to U.S. taxpayers, little adjustment of income and tax data was necessary to estimate potential revenue.

Our estimate of 1983 personal income tax revenue from the Virgin Islands was based on aggregate collections data because detailed information on taxpayers' income, deductions, exemptions, and credits was not readily available. We used collection and tax refund data from the



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Virgin Islands Department of Finance's 1983 Comprehensive Annual Financial Report, which shows the source and use of government operating funds.

Revenue from fully extending corporate income taxes also was based on collection data. To the collections, we added 1983 income tax rebates provided to certain corporations and individuals through the Virgin Islands Industrial Development Program. Such rebates would not be allowed under the federal tax system. Rebate data were obtained from the Virgin Islands Bureau of Internal Revenue.

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## Guam

Because Guam "mirrored" the U.S. tax Code, and area taxpayers were taxed almost the same as U.S. taxpayers, few adjustments on income tax data were necessary to estimate tax revenue.

We obtained aggregate tax data for tax year 1983 from Guam's tax information system—a computerized data collection system.<sup>4</sup> The federal government withheld income taxes from federal employees residing in Guam, including active military personnel, and transferred such funds to Guam under federal law. We gathered data on tax revenues generated through this provision from the U.S. Treasury and Guam's tax agency. Using aggregate tax liability reported through Guam's information system, we added transfers from the federal government to calculate personal tax liability.

We estimated corporate tax revenue from data reported in Guam's tax information system. Total taxes included \$3.3 million rebated to corporations under Guam's tax incentives program.

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## American Samoa

Because there were significant differences between the tax systems in American Samoa and the United States, we adjusted income and tax data to estimate revenue from fully extending federal taxes. Aggregate 1983 tax liability data were obtained from American Samoa tax officials. They also provided information on the area revenues generated from the minimum tax, the number of tuna workers exempt from American Samoa income taxes, the number of filers who would be eligible for an earned income credit under the U.S. Code, and the estimated amount of investment credit on buildings. These items were treated differently

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<sup>4</sup>We did not assess the reliability of information generated through this automated system.

in American Samoa, and therefore required adjustments to estimate revenue, as follows:

- Exempt tuna workers - As part of the tax incentives granted to tuna canneries, American Samoa exempted from income taxes employees stationed on tuna boats. If income taxes were fully extended, this exemption would not exist. Thus, the amount of the exemption was added to the actual area tax. This adjustment was equal to the number of exempted filers times the average tax liability per return, which we added to the area tax revenue.
- Minimum tax - The 2-percent minimum tax collected by American Samoa represented 17 percent of the total personal tax liability. We subtracted this amount from the areas' tax revenue.
- Earned income credit - The number of American Samoa filers who would have been eligible for this credit was identified by American Samoa tax officials. We multiplied this number by the average earned-income credit claimed by U.S. households in 1983, to estimate total credit. We then subtracted this credit from area tax revenue.
- Investment credit - American Samoa allowed this credit for buildings used in business, as well as machinery and equipment. An adjustment was made by adding the estimated credit for buildings to the total tax revenue.

Also, American Samoa had amended its tax system to allow the government to grant full or partial tax exemptions to corporations as an incentive to promote economic development. These exemptions, which would not be allowed under the federal system, reduced the corporate tax revenue. Consequently, we added them to the aggregate area corporate tax.<sup>6</sup>

## Long-Term Estimate

Our long-term estimate of federal revenue after businesses react to tax extension reflects only taxes from certain U.S. manufacturing firms operating in Puerto Rico in 1983 that historically had claimed section 936 credits. If this credit were eliminated under full U.S. tax extension, we believe that certain firms in the pharmaceutical, electronics, and food-processing industries would continue to operate in Puerto Rico or relocate to the U.S. mainland. In either event, they would be fully taxed. Together, these firms claimed about \$1.3 billion in section 936 credits in

<sup>6</sup>We did not adjust corporate tax liability for other differences because (1) the revenue effect would have been insignificant according to American Samoan officials or (2) insufficient data were available.

1983, or about 67 percent of about \$1.9 billion in section 936 credits taken in that year. Assuming their profits remained unchanged, we believe these corporations would generate about \$1.3 billion in tax revenues for the U.S. Treasury.

Additional revenues may be received from other firms operating in Puerto Rico, from Puerto Rico personal income taxes, and from the other areas. Nonetheless, revenues from these sources likely would be lower than we estimated for 1983, although there were too little data to quantify this reduction. For example, many Puerto Rico-based firms may provide supplies or services for manufacturing companies claiming section 936 credits. The operations of supplier firms may be reduced or curtailed to the extent that their customers close or relocate to U.S. or foreign sites.

Fully extending U.S. income taxes could affect local corporations in other ways also, because we assume that U.S. income taxes would replace area income taxes. Thus, for example, the areas no longer would be able to give corporations rebates or exemptions from local income taxes. In calendar year 1983, Puerto Rico forgave \$2.34 billion in Puerto Rican income taxes under its Industrial Incentive Program. This also could reduce or curtail operations for Puerto Rican firms.

The likely business contraction would affect employment and, by extension, personal tax revenues. An estimated 54,000 jobs would be lost from companies claiming section 936 credits but expected to close or relocate to foreign areas, thereby escaping federal taxation until profits were returned to and taxed by the United States. Assuming an employment multiplier for major manufacturing industries in Puerto Rico at about 1.4—about the same as in the United States—Puerto Rico's economy would lose about 22,000 additional jobs. Given a 1982 labor force of about 918,000 (of whom 199,000 were unemployed), this contraction would have increased unemployment about 8.2 percent. As a result, personal tax revenues likely would be lower over the long term than projected for 1983.

Area officials in the Virgin Islands, Guam, and American Samoa also foresaw adverse economic impacts from fully extending U.S. income taxes, especially due to the restriction of the areas' capacity to continue local business incentives. To the extent that these areas' economies would be affected by full tax extension, many of the same factors affecting potential taxes in Puerto Rico would tend to reduce tax revenues in these areas below our 1983 projections.

# Selected GAO and Other Reports and Studies Related to Selected Insular Area Welfare Programs and Income Taxes

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Followup of Guam's Administration of Its Income Tax Program, GGD-84-11. October 26, 1983.

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Experience of Past Territories Can Assist Puerto Rico Status Deliberations. GGD-80-26. March 7, 1980.

The Government of Guam's Administration of its Income Tax Program. GGD-80-3. October 3, 1979.

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Citibank. Economic Challenges Facing Puerto Rico. March 1985. ICF, Incorporated. Benefit-Cost Analysis of Section 936. September 1985.

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# Comments From the Governor of Puerto Rico

COMMONWEALTH OF PUERTO RICO

OFFICE OF THE GOVERNOR  
SAN JUAN, PUERTO RICO 00901



June 30, 1987

Mr. Richard L. Fogel  
Assistant Comptroller General  
Human Resources Division  
U.S. General Accounting Office  
Washington, D.C. 20548

Dear Mr. Fogel:

Thank you for giving us the opportunity of reviewing and commenting on your Draft Report Welfare and Taxes: Extending Benefits and Taxes to Puerto Rico, Virgin Islands, Guam and American Samoa. Our detailed comments are enclosed.

The fundamental flaw with the GAO Draft Report is attributable to the nature of the Congressional inquiry. The fundamental question should not be how the United States Treasury can extract additional revenues from an Island whose per capita income is one-third that of the U.S. mainland, but how the United States can further the long-established Congressional goal of promoting economic growth and fiscal autonomy in Puerto Rico. The proper and enlightened emphasis should be on the creation of new jobs, assuring the sense of dignity and well-being they foster, not the anxiety and misfortune of job destruction and greater dependence that would be the inevitable and predictable consequence of fully extending federal social welfare programs and federal corporate and income taxes to Puerto Rico and the U.S. territories.

The body of the report makes clear that fully extending federal income taxes to Puerto Rico would be an economic disaster for both Puerto Rico and the United States. The \$2.4 billion in additional taxes taken out of our economy would exceed the \$1 billion net benefit of fully extending welfare programs by \$1.4 billion annually. Obviously, the



Mr. Richard L. Fogel  
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people of Puerto Rico could not support such a regressive plan. Moreover, the additional tax revenues to the United States would largely evaporate in time as firms left Puerto Rico in response to the steep increase in taxation, taking thousands of jobs with them and leaving the economic of Puerto Rico in a shambles.

The imposition of a net federal tax increase of more than a billion dollars, or almost 8% of GNP, on a developing economy with unemployment at nearly 17 percent, would inevitably result in even higher unemployment and economic stagnation. The hope of a better tomorrow for our children that energizes Puerto Rico today would be the first casualty of such a misguided approach.

The draft report does not follow through on the logical implications of its findings with a recommendation that Congress not tinker with a tax regime that has been so successful in developing the economy of Puerto Rico and creating thousands of jobs. Instead, it makes the inconsistent suggestion that, if Congress wishes to pay for extending welfare programs by imposing federal taxes, it should do so by gradually imposing federal corporate income taxes on businesses here.

A policy of gradualism will not work. It would immediately shut off new investment in Puerto Rico, and hasten the departure of existing firms. Enterprises would quickly see that tax incentives -- which the report agrees are "critical" to our industrial development -- would no longer be reliably available in Puerto Rico.

Unfortunately, we have seen the dire effects that merely proposing to remove federal tax incentives can have on investment and jobs in Puerto Rico. When in November, 1984, the U.S. Treasury proposed the repeal of Section 936 and its replacement with a far less effective jobs credit. New investment dried up. Firms that were planning to build or enlarge factories in Puerto Rico shifted their investments to other areas. Some businesses even left for tax advantaged areas with more stable and reliable tax incentives.

Working with the Reagan Administration and the Congress, Puerto Rico helped devise a compromise that was ultimately enacted in the Tax Reform Act of 1986. Section 936 was retained with a few relatively minor modifications, and indeed broadened in order to promote economic development in the entire Caribbean Basin.

Mr. Richard L. Fogel  
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The response to Administration and Congressional assurances that Section 936 would indeed be a permanent tool of economic development for Puerto Rico and the Caribbean has been extremely gratifying. Since 1985 total employment in Puerto Rico has increased by more than 82,000. The unemployment rate, nearly 22 percent when I took office in January of 1985, has declined by more than 6 percentage points.

But much remains to be done. Unemployment still remains too high, at 16.6 percent. The labor force participation rate in Puerto Rico has not exceeded 45%, compared to a 67.2% rate on the U.S. mainland. This Administration has placed the highest priority on continuing the robust growth and job creating industrial development that tax incentives make possible.

The imposition of federal taxation -- or even the threat of it -- would be truly catastrophic. It would undo the impressive progress of the past months and deny our future prosperity. Puerto Rico's economic growth and its continued development requires the continuation of fiscal and tax policies supportive of private investment. The extension of U.S. corporate and personal income taxes would grievously injure Puerto Rico's growth potential and force the Island down the destructive road of high taxes and spirit-deadening dependency.

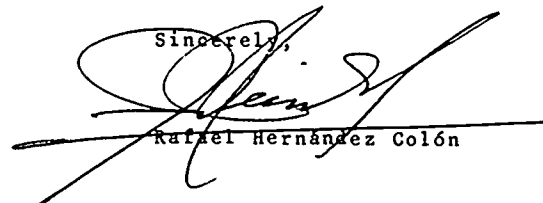
GAO should not again impose on Puerto Rico the costly uncertainty regarding the permanence of section 936. Only a few years ago, the 1982 TEFRA legislation was advertised as satisfying all of Treasury's concerns about abuses of section 936, and a bringing much needed stability to the tax environment in Puerto Rico. Only a few months ago, Congress again amended section 936, again indicating that the section would not be revisited in the near term.

Instead of suggesting that Congress should again consider repealing section 936, with the ink on the 1986 Tax Reform Act compromise hardly dry, GAO should remind Congress of the need to honor its commitment to bring stability to the tax regime in Puerto Rico. Constant amendment to tax laws relating to Puerto Rico undermines the confidence and stability that is critical to our ability to attract new investment and create more jobs.

Appendix VII  
Comments From the Governor of Puerto Rico

Mr. Richard L. Fogel  
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Please do not encourage further experimentation with the Puerto Rican economy and the welfare of thousands of Puerto Rican families.

Sincerely,  
  
Rafael Hernández Colón

Enclosures

COMMENTS OF THE GOVERNOR OF PUERTO RICO  
RAFAEL HERNANDEZ COLON  
ON THE GENERAL ACCOUNTING OFFICE (GAO) DRAFT REPORT  
WELFARE AND TAXES: EXTENDING BENEFITS AND TAXES  
TO PUERTO RICO, VIRGIN ISLANDS, GUAM AND AMERICAN SAMOA.

GAO has been asked to analyze the potential effects of simultaneously extending certain federal welfare programs and federal corporate and income taxes to Puerto Rico, as well as the Virgin Islands, Guam and American Samoa.

At least one recommendation to Congress is essential and indeed inescapable from the body of GAO's analysis: It would be self-defeating for Congress -- and an economic tragedy for Puerto Rico -- to attempt to finance an extension of federal welfare programs through the unprecedented imposition of federal corporate and income taxes on the Commonwealth's businesses and residents.

According to the GAO's estimates -- which the report admits are highly speculative and unreliable -- the net macroeconomic effect of simultaneously extending full federal taxation and federal social programs to Puerto Rico would be regressive, draining \$1.4 billion out of the Puerto Rican economy annually. While Puerto Rico would receive approximately \$1 billion of additional federal spending, and save \$88 million in local welfare expenditures, it would suffer an increased federal tax burden of \$2.4 billion, and need to impose \$1.2 billion in local taxes.

The long-established Congressional goal of promoting economic growth and fiscal autonomy in Puerto Rico would be undermined by the destruction of the thousands of jobs which GAO recognizes would result from the imposition of a net federal tax increase of more than a billion dollars, or almost 5% of GNP, on a developing economy with unemployment at nearly 17 percent. The loss of even one job is unacceptable. The people of Puerto Rico want to work. Giving them the opportunity is the highest priority of this administration. It would be tragic if federal policy were to quash opportunity, and defeat our efforts at assuring economic growth and vitality, and providing a better tomorrow for our children.

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Tax Incentives Are "Critical" to Puerto Rico

The economic development of Puerto Rico has been possible through enlightened federal and Puerto Rican policy supportive of private investment. For over 65 years, Puerto Rico has relied on tax incentives -- its own and those made available by the federal government -- to bring industry and jobs to an island that has few natural economic attractions. Located far from major markets, with no mineral resources and high energy costs, Puerto Rico depends on these tax incentives for its economy viability. Apart from the fiscal and tax autonomy, U.S. law actually exacerbates Puerto Rico's economically disadvantaged position. The federal government imposes higher costs on business in Puerto Rico than they would have to bear in neighboring jurisdictions in the Caribbean or competing economies in the Far East and elsewhere -- such as the U.S. minimum wage, environmental restrictions, and the requirement that goods and raw materials shipped by sea between the U.S. and Puerto Rico be transported on expensive U.S. flag ships.

The imposition of federal corporate and personal income taxes on the Commonwealth would destabilize our entire economy, throw nearly 10% of our workforce out of work, and force many to migrate.

This radical change in federal policy would undermine Puerto Rico's efforts to address its most critical economic problem-- a declining capacity to generate jobs sufficient to employ the Commonwealth's working age population. Our Administration has placed the highest priority on restoring robust growth, and increasing job creation on the island. Since 1985 total employment has increased by more than 82,000, and the unemployment rate has fallen by more than 6 percentage points. But much remains to be done. Unemployment still remains too high, at 16.6%, and the labor force participation rate remains below 45%.

The imposition of federal taxation on our economy would be truly catastrophic. It would not only undo the impressive progress of these past two years, but threaten the possibility of future prosperity. Puerto Rico's economic growth, and its continued development requires the continuation of fiscal and tax policies supportive of private investment. The extension of U.S. corporate and personal income taxes would grievously injure our growth potential and erroneously force the island down the destructive road of high taxes and dependency.

It is not surprising that the draft GAO report concludes that "federal tax benefits appear to have been critical to Puerto Rican industrial development to date" (page 148) and "are likely to

Now on p. 128.

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Now on p. 129.

remain a major inducement for foreign investments in Puerto Rico" (page 150). It is surprising, though, that the draft GAO report does not counsel against this radical change in federal policy which is "critical", indeed vital, to the future economic prosperity of the Commonwealth.

Economic Consequences of the Imposition of Federal Corporate and Income Taxes.

The economic consequences of extending federal corporate and income taxes to the Commonwealth would be disastrous. Based on a detailed and complete modeling of the dynamic effects on the Puerto Rican economy of a repeal of section 936 and its replacement with a wage credit, the economists at ICF, Inc., concluded that 61,000 jobs almost 9% of all private sector jobs in Puerto Rico, would be lost. We urge that GAO give careful study to the ICF report, one of the most thoughtful and comprehensive studies of the impact of federal tax incentives on the Puerto Rican economy that has yet been done.

The full imposition of federal corporate and individual income taxes in Puerto Rico would have an even more severe impact, since (1) all corporate activity, whether of Puerto Rican or foreign corporations, or 936 subsidiaries of U.S. firms, as well as (2) all personal income would be subject to federal taxation.

Even under GAO's admittedly more limited assumptions, GAO estimated a loss of 45,700 direct jobs. Job losses of this magnitude are clearly unacceptable, and would have devastating and regressive social effects, increasing our unemployment rate by more than 20%.

The Mythical Federal Revenue Increase

The GAO study employs an admittedly limited methodology. It utilizes a static, accounting-type approach which fails to analyze long-term, dynamic effects. The draft report "estimates" that federal revenues would be about \$2.7 billion higher if federal income taxes were extended to Puerto Rico, the Virgin Islands, Guam and American Samoa. That number is subject to so many infirmities, uncertainties and contingencies, most of them acknowledged in the draft report itself, that it should not be dignified as a GAO estimate. The colloquial "guesstimate" might have been a better expression, but even that term connotes a more reasoned and reliable prediction than can be claimed for the \$2.7 billion figure. At most, GAO should have provided low and high estimates, thereby clearly communicating the high degree of error



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involved, rather than attempting to place a dollar figure on these effects.

The GAO revenue estimates are significantly overstated for the following reasons:

1. The "estimate" is based on 1983 tax return data, already four years old. It does not fully reflect the effects of the 1982 TEFRA amendments, which were estimated to generate more than \$350 million a year in additional revenue.
2. The "estimate" fails to reflect the substantial reductions in corporate and individual tax rates enacted as part of the historic Tax Reform Act of 1986.
3. The "estimate" fails to incorporate the amendments to section 936 effected by the Tax Reform Act of 1986, which was estimated to capture more than \$300 million in additional revenue over five years.
4. The "estimate" does not take account of the dramatic decrease in social security, personal income and corporate tax revenues that would accompany the migration of hundreds of businesses and thousands of jobs from Puerto Rico if federal taxes were imposed.
5. The "estimate" does not take account of the reduction in federal revenues that would result from the deduction of Puerto Rican income taxes on the federal income tax returns of individuals and businesses in Puerto Rico. The assumption that Puerto Rico would simply cede income tax jurisdiction to the federal government without availing itself of income taxes which presently represent 32% of the Government's budget, particularly when its residents can deduct such taxes on their federal returns, is absolutely unrealistic.

The draft report's industry-by-industry analysis (pages 156-159) forecasts "a likely relocation of firms to more tax-advantaged locations." It predicts that "annual federal tax revenue could decline significantly over the long term primarily because some businesses likely would close, relocate, or down-size operations after tax incentives disappeared" (page 4). The draft report suggests that "total annual federal revenue could decline

Now on pp. 133-135.

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to \$2.1 billion or less" (emphasis added). Even this number appears to be nothing more than a shot in the dark.

Need to Maintain Puerto Rico's Tax Base.

Most unrealistic is the assumption that Puerto Rico could or would respond to the imposition of federal taxation by abolishing its own taxes. Puerto Rico could not absorb the contemplated revenue loss of more than \$1.2 billion, which accounts for more than 32% of local spending. As the GAO report makes clear, increased federal assistance will only displace \$88 million in local spending.

The public sector employs more than 180,000 workers -- 30,000 more than in manufacturing -- and carries a heavy burden of responsibility, particularly in education with its younger education than the U.S. These essential services cannot be curtailed, and these workers must not be added to the unemployed. Thus, Puerto Rico would inevitably have to maintain the \$1.2 billion in local revenues GAO assumes Puerto Rico could somehow do without.

The alternative of a sales tax, supported by some GAO interviewees, must be avoided for its regressive effects. The draft report fails to point out that Puerto Rico presently levies a 6.6% excise tax, which is higher than any state sales tax in the United States, and a 19.8% excise tax on electrical products, automobile parts and certain other items, and a tax of automobiles which dwarfs that of any state. An increased excise tax or a sales tax on top of the current excises is simply out of the question, and would unconscionably burden Puerto Rico's lower-income groups.

Thus, Puerto Rico would forcibly have to retain its present corporate and income taxes. The combined effect of federal and local taxes would necessarily result in a tax increase for all taxpayers, and have a regressive effect, further increasing the tax load on our lower income groups. Equity considerations aside, the combined federal and local tax burden would so weigh over the economy as to destroy the incentive structure vital to growth. The draft report falls woefully short in analyzing the economic effects on Puerto Rico of (1) either losing its tax base, or (2) the extraordinarily high tax rates that would result from the full imposition of federal and Puerto Rico corporate and income taxes.

Social and Human Needs of Puerto Rico

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In evaluating the desirability of fully extending social programs to Puerto Rico the GAO study fails to assess the most important consideration that should guide Congressional policy in this area-- whether existing federal programs fully satisfy the most basic human needs of U.S. citizens in Puerto Rico. By ignoring this fundamental consideration, Congress was deprived of an assessment of the extent to which the human needs of U.S. citizens in Puerto Rico are met. For example, under present federal policy, the more than 121,000 aged or disabled Puerto Rican residents not now eligible for assistance under SSI receive a total federal monthly assistance of only \$32 as compared with \$314 in the U.S. mainland. Clearly, increasing this assistance presents one of the more compelling cases for enhanced federal social spending. These determinations should be governed exclusively by a concern for providing all U.S. citizens the minimum standard of living and assistance that any U.S. citizen should have.

The Commonwealth Relationship

The draft report errorously concludes that the nature of the Compact between the United States and Puerto Rico, and whether Puerto Rico is a territory subject to the plenary authority of Congress "has not been resolved by the courts." (page 76) Numerous court decisions have fully recognized that:

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1 Although GAO recommends that Congress slowly and simultaneously increase federal tax collections and social spending, it fails to point out that in recent years Congress has significantly increased federal tax revenues without an offsetting increase in social spending. Through the tax reform process Congress has already increased federal tax revenue attributable to Puerto Rico-source income. The TEFRA amendments were expected to increase federal tax revenue from companies doing business in Puerto Rico by nearly \$352 million a year, and the 1986 Tax Reform Act is expected to increase federal revenue by more than \$300 million over a five-year period. There has not been an inexorable linkage connection between federal taxes and federal spending in Puerto Rico, given the nature of our economy, there cannot be.

Now on p. 56.

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"(i)n 1952, Puerto Rico ceased being a territory of the United States subject to the plenary powers of Congress as provided in the federal constitution. The authority exercised by the federal government emanated thereafter from the Compact itself. Under the Compact between the People of Puerto Rico and the United States, Congress cannot amend the Puerto Rico Constitution unilaterally and the government of Puerto Rico is no longer a federal government agency exercising delegated power."  
United States v. Quinones, 758 F. 2d 40 (1st Cir. 1985).

See also Posadas de Puerto Rico Associates v. Tourism Co. of Puerto Rico, 106 S.Ct. 2968 (1986); Rodríguez v. Popular Democratic Party, 457 U.S. 1, 8 (1982); Examining Board of Engineers Architects and Surveyors v. Flores de Otero, 426 U.S. 572, 594 (1976); Calero-Toledo v. Pearson Yacht Leasing Co., 416 U.S. 663, 672-673 (1974); Mora v. Mejías, 200 F.2d 377, 386-88 (1st Cir. 1953).

Congress deserves a better exposition of the significant and sensitive issues involved in extending federal taxation to Puerto Rico.

#### CONCLUSION

Although the draft report makes a compelling case for not tinkering with federal tax incentives in Puerto Rico, the reader is left somewhat bewildered by the report's failure to state the obvious recommendation to Congress: eliminating tax incentives is not the way to pay for an increase in federal welfare benefits in Puerto Rico.

The draft report's suggestion (at pp. 8-9, 101) that if Congress wants to make changes in the tax structure it should consider doing so by partly reducing Section 936 benefits further confuses the issue because it is inconsistent with the report's cogent warnings that tax incentives are "critical" to industrial development in Puerto Rico and that their repeal or reduction could lead to massive relocations and job losses. Indeed, even renewed public debate over this section tool of economic development could be extremely harmful to Puerto Rico. Moreover, the Administration and Congress have given their assurance that section 936, as recently modified by the Tax Reform Act of 1986, will be preserved as a tool for economic development in Puerto Rico and the Caribbean.

According, neither a full nor a partial repeal of section 936 is an option that should be suggested for consideration.

Now on p. 5.

# Comments From the President of the Senate of Puerto Rico



*Miguel A. Hernández Aguiar*  
President

*Commonwealth of Puerto Rico  
Senate  
Capitol  
San Juan, Puerto Rico 00901*

June 2, 1987

Mr. Richard L. Fogel  
Assistant Comptroller General  
US General Accounting Office  
Washington, DC 20548

Dear Mr. Fogel:

I am satisfied and grateful for the opportunity that you have given us to submit our comments to your preliminary report "Welfare and Taxes: Extending Benefits and Taxes to Puerto Rico, Virgin Islands, Guam and American Samoa". They consist of two parts: this transmittal letter which summarizes my views and the analysis of the proposal based on our econometric model.

This is a most important report in terms of the subject matters that it covers. As proof of how politically sensitive these themes are, I am enclosing a copy of the headline the disclosure of the contents of the report made in the daily English newspaper San Juan Star, on April 26, 1987.

The two areas covered by the Report, being so closely related to the political status question in Puerto Rico, should be researched properly, comprehensively and professionally. Even though this previous advice were fully implemented, it may not be enough.

Direct participation by the politically interested parties in Puerto Rico, since the very inception of the study, is a most desirable element of the methodology to be applied. It is not enough that reactions be requested after the report has been drafted. It is not even enough that the information be collected in Puerto Rico during short or extensive visits. It is a matter of involving the representatives of the parties directly concerned in the

Appendix VIII  
Comments From the President of the Senate  
of Puerto Rico

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research so that they may be acquainted from the preliminary and planning stages, with the specific objectives to be pursued, the gathering and analysis of the data, the constraints inherent to the undertaking and the conclusions finally arrived at.

If such procedure were followed, it would generate a sense of trust; its results would be recognized as free of any disguised intentions or biases distorting the value of the whole effort.

As these subjects are so intertwined to the status resolution of the United States-Puerto Rico relations, there are a considerable number of related issues and tie-ins which must be looked at simultaneously with the subject matters being researched.

Keep in mind, for example, that Puerto Rico is presently one of the leading buyers in the United States market. We are required to use the United States merchant marine in moving to or from Puerto Rico. We provide the United States the largest and most complete naval base in the Atlantic coast. Puerto Ricans are recruited into the United States military forces as if we were a state. Thus, Puerto Rico's contribution to the United States can not be looked at solely from the point of view of our tax contributions to the United States Treasury.

My position is summarized in the following observations:

1. I am gravely concerned and personally opposed to the report, even though it appears to assume a neutral position on the subjects covered. It discusses a proposal which our Administration is not presently pursuing nor intends to pursue in the coming years. It is an unilateral undertaking that I do not endorse.

2. It is being brought to public discussion in a most inopportune occasion. It injects an status oriented issue into our politically heated environment when our repeatedly scated policy has been to postpone any status oriented issue while we reconcile our divided families and rehabilitate the Commonwealth economy.

3. It relates to a radical change in the United States-Puerto Rico relations, which will have a disastrous impact in our economy. It will affect the individual and corporate taxpayers and our collective lives as well. There has never been a natural, economic or social disaster of the nature and magnitude that this change may trigger.



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4. It will mean the closing of those manufacturing plants operating in Puerto Rico under Section 936 of the United States Internal Code providing the highest paid jobs.

5. Most importantly, it would destroy the promotional effectiveness of the Economic Development Administration to induce new manufacturing plants to establish their operations in Puerto Rico.

6. The chain reaction of this unfavored change will be everlasting and definitely negative. The elimination of the best paid manufacturing jobs means the loss of wages and salaries to the tune of close to 20% of our net income. This unexpected, undesired and catastrophic drawback will affect our purchasing capability of goods and services to feed, clothe and shelter our growing population. Larger members of our families will go into the Nutritional Assistance Program, the assistance to families with dependent children, and the supplemental security income. Rather than a developing economy, we would change into a grossly dependent economy.

7. Local banks would lose a sizeable part of their deposits, mainly those held by 936 manufacturing concerns. These deposits -close to 40% of the total deposits held in Puerto Rico- would be transferred away from Puerto Rico. Such a sizeable loss in bank deposits would mean reduction in the number of bank employees with its consequent loss of a payroll that runs into the millions.

8. Just as important would be the consequent effect over the lending activity in commercial, industrial, personal and real estate operations of the banks holding these deposits. The interest rate will inevitably go up.

9. Our local government will lose a substantial amount of funds badly needed for financing our public services. Whatever income, which presently enters into our Commonwealth Treasury, is deviated to the Federal Treasury means children that must be left out of school; policemen that will not protect our families; newborn, children, young, adults, old aged, and handicapped members of our population that will not be cared in their health needs; roads that will not be built nor maintained, and, thus, we may add to the list of public services that will be sharply curtailed or eliminated.

Appendix VIII  
Comments From the President of the Senate  
of Puerto Rico

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10. There will not be any possibility of substituting the lost revenue with new taxes. When a recession of this type is created, it is simply unjust -not to say an impossible political decision- to increase the tax burden to individuals and corporations who hardly can survive.

Unless you could convey to the Congress the disastrous impact of extending the income tax code to the Puerto Rican taxpayer, I would advice you to postpone the submission of this report. In the meantime, you could delve in greater depth into the social and economic circumstances of present Puerto Rico in order to come to a more comprehensive and factual presentation of this controversial matter.

Sincerely



Miguel A. Hernández, Agosto

Enclosure

Appendix VIII  
Comments From the President of the Senate  
of Puerto Rico



*Agustín A. Hernández Agostini*  
President

*Commonwealth of Puerto Rico  
Senate  
Capitol  
San Juan, Puerto Rico 00901*

June 2, 1987

AN ANALYSIS OF THE  
GENERAL ACCOUNTING OFFICE REPORT  
ON "WELFARE AND TAXES: EXTENDING BENEFITS  
AND TAXES TO PUERTO RICO, VIRGIN ISLANDS,  
GUAM AND AMERICAN SAMOA" (REVISED)

The General Accounting Office Report is an attempt to measure the benefits of extending to Puerto Rico certain welfare type programs to which all states of the Union are presently entitled. At the same time the study measures the amounts of corporate and personal taxes that Puerto Rican residents would pay if the Federal Tax Code would be extended to Puerto Rico. According to the Report, the estimated additional transfer payments to be received by Puerto Rico would amount around 1 billion dollars. The estimated additional federal taxes to be paid by individuals and corporations would amount to 2.4 billions of dollars.

In this analysis, we measure some of the economic impacts of the changes in the flow of funds between the economies of Puerto Rico and the United States, that result from the General Accounting Office study. For this purpose, we have used the Senate's Econometric Model. We have emphasized the employment and Gross National Product impact

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because these are the most critical variables in the economy. However, it should be emphasized out that the impacts of the increases in taxes and transfers imply a radical change in the economic structure of Puerto Rico.

According to the Report, the estimates of additional transfers and taxes are the following:

<u>Additional Transfers</u>	MM\$
a. SSI	411.0
b. AFDC	72.3
c. Medicaid	326.2
d. Foster Care	3.1
e. Child Support	0.5
f. Food Stamps	<u>188.0</u>
TOTAL	1001.1

<u>Additional Taxes</u>	
a. Corporations	2080
b. Individuals	<u>365</u>
	2445

The approach of the report is that of "comparative statics", which does not take into consideration the dynamic implications of the indicated changes. In fact, these impacts would be of such magnitude that the estimate of taxes and transfers will be considerably different from the original calculations made by the General Accounting Office.

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The economic policy reflected in the Report implies a radical departure from the economic strategy that transformed Puerto Rico during the last three and a half decades. The Puerto Rican development strategy has relied mainly on the manufacturing sector. This sector is the cornerstone of the Puerto Rican economy. Particularly important is the export sector of manufacturing, which is favored by the existing tax laws. In fact, the transformation of Puerto Rico from the backward conditions of the late forties to the modern society of the eighties is mainly due to the role that the manufacturing sector has played in the economy. This sector employs about 150,000 persons, which in turn generates another 140,000 indirect jobs. This means that 32% of the total Island's employment depends on the manufacturing sector.

We have estimated that, the portion of the manufacturing export sector that could be directly affected by the extension to Puerto Rico of the Federal Tax Laws, generates about 80,000 direct jobs and another 90,000 indirect jobs. However, the significance of manufacturing in the economy goes beyond the employment opportunities that have been created. This is the main productive sector of Puerto Rico and it is, in fact, the main training center for our labor force. The side effects related to the formation of a highly qualified labor force, including a sophisticated and

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numerous managerial class has created some of the conditions for further economic expansion in the Island. However, it should be pointed out that Puerto Rico is not a developed society, but one in transition from the take-off stage of economic development to that of a sustained growth stage. Our level of personal income per-capita is about one third of that of the United States.

It is our considerate opinion that, the changes described in the General Accounting Office document will imply a fatal blow to the manufacturing sector of Puerto Rico and to the related business activities. If all manufacturing activity that has prospered under existing tax preferential treatment (936 code), were to migrate from Puerto Rico, total employment losses would be of the magnitude of 170,000 direct and indirect jobs, which means a reduction in total employment of about 20%, which could imply an unemployment rate of well over 35%. Even if only half of those plants were to migrate, the level of unemployment could reach over 26%. It is not an exaggeration to conclude that the implementation of the Federal Tax Code in Puerto Rico could imply the eventual destruction of a large part of our industrial base. We must keep in mind that, at the present time, and due to the fierce competition from the East-Asian countries, many of our industries are going through a most difficult situation. If Federal taxes



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were imposed, these will develop a further determination in the relative profit rates between Puerto Rico and the alternative most profitable country.

DIFFERENCES BETWEEN AFTER TAX PROFIT RATES OF PUERTO RICO  
AND THE ALTERNATIVE MOST PROFITABLE COUNTRY

SECTORS	DIFFERENCE IN PROFIT RATES (With Federal Taxes)
Food	-6.33
Apparel	-8.6
Pharmaceutical	-5.8
Electronics	-11.8
Instruments	-13.2

Source: Benefit Cost Analysis of Section 936. ICF.  
Washington D.C. 1985.

As the experience of recent years indicates, industrial migration from Puerto Rico will be oriented toward other developing countries and not to the United States. Consequently, the estimates of Treasury's tax income of 2.4 billions of dollars reflected in the General Accounting Office Report are grossly over-estimated. The Report indicates that if the adverse impacts are taken into consideration, tax income to the U.S. Treasury would be 2.1

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billion dollars instead of 2.4 billions. It is obvious that a reduction of only 12.5% in tax income, due to the effects of industrial migration and other negative impacts, implies only a marginal change. However, all the evidence points out in the direction of a radical change in the economic structure of the Island. Unfortunately, the General Accounting Office Report does not explain the methodology used to compute such a small reduction in potential tax income.

A recent study, carried out by a Washington firm, indicated that, if the present preferential tax treatment were to be eliminated and substituted by a massive wage subsidy program, direct employment losses could range from 24,000 to 56,000. If we apply the employment multiplier of our model, this could mean a reduction of 43,000 to 100,000 jobs, which means that even in this case the employment impacts could be very significant. Given these reductions in employment, then output and income will be also reduced. This will induce a corresponding reduction in tax revenues.

An economic disaster of such magnitude will have very grave social consequences, including a massive migration to the United States, increases in crime rates and other drug related social problems. Puerto Rico has more than double the unemployment rate estimated for the United States. Our crime rate is also relatively high. We do not think we

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should aggravate the existing situation with an alternative that implies more welfare and less production. In fact, what we need is precisely the opposite.

Given the deterioration in social conditions, the amount of Federal transfers to Puerto Rico would be more than the one estimated in the Report. Obviously, these transfers could mitigate part of the negative effect of the dismantling of the manufacturing sector.

We have estimated that the employment effects of a billion dollars in Federal transfers would be about 49,000 jobs. The problem is that there is a qualitative difference between this gain in employment and the employment losses in the manufacturing sector. The economy, instead of being fueled by exports of goods and services would be supported by Federal Transfers, creating a non-viable economic structure, depending on the fluctuations of the expenditures policy of the Federal Government. This is not the kind of society that the Puerto Rican people and its duly constituted government have defined for themselves. The road to progress is through economic development and self reliance and not through dependence and welfare.

We have to recognize that the role of Federal Transfers is already very high in this economy. According to our econometric model, transfers generated 24% of the Gross National Product and 26% of the total employment during

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1985. An increase in Federal transfers by 1 billion would increase its role to about 30%, if other things stay equal. But, the substantial contraction in the manufacturing sector could expand the proportional role of Federal transfers, depending on the magnitude of the manufacturing contraction. If half of the 936 manufacturing sector migrates, that could imply a reduction of about 20% in the Gross National Product of Puerto Rico. The reduction in G.N.P. is larger in percentage terms than the reduction in employment because the level of output per man in the manufacturing section is larger than the average. On the other hand, the estimated increases in Federal transfers would increase Gross National Product by about 5%. So the net effect of these two variables (exports and transfers), in terms of Gross National Product, could be a reduction of about 15%. This is assuming a migration of half the 936 manufacturing sector.

Besides the negative impacts in the manufacturing sector, we have to consider the negative effects on local corporations and individuals. The Report does not provide information related to the breakdown of the 2.08 billions of dollars in additional corporate taxes. But, a substantial portion of these taxes will be paid by local businesses other than manufacturing. In order to measure the impact on local business of the possible increases in costs, related

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to this additional tax burden, we would need more details of the methodology used in the Report. Total Corporate taxes in Puerto Rico amounted to 621.1 millions of dollars in fiscal year 1986 and personal taxes in 1985 amounted to 727 millions of dollars. An increase of 365 millions of dollars in personal taxes, implies a personal tax burden 50% higher than the one that existed in 1995. The implications, in terms of incentives to work and to invest, are very difficult to quantify, but undoubtedly, they could be disastrous to this economy. The same thing could be said with respect to a probable substantial increase in taxes to local firms. If the resulting tax burden is too high, the changes considered in the G.A.O. Report could then induce a reduction in local taxes and, consequently, in the level of government activities and services. How much will be the reduction in this level of activity is very difficult to quantify with precision, because it will depend on the reduction of the tax burden considered appropriate to keep local business profitable. However, it is clear that the contraction could be a very large level of much needed public services in areas such as education, which receives the largest share from the present Government budget.

Another aspect of the problem is how Federal transfers are used in Puerto Rico. Most of the programs related to these transfers were designed to satisfy the needs of a

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developed society such as that of the United States in which many social problems have a marginal character. However, Puerto Rico is at a much lower level of development and our needs and priorities are significantly different. Federal programs provide many useful services, but such appropriations could be used better -in terms of our local reality- if only Congress could allow us the required flexibility in implementing them. An example in point is the food stamp program now operating as the Nutritional Assistance Program. If this program had been originally implemented as a local developmental program, the total amount of jobs created could have implied the reduction in almost 40% in the number of unemployed. At the present time, the program generates about 20,000 jobs in comparison with a figure of 90,000, estimated to be created through a local developmental program.

ALTERNATIVE EMPLOYMENT IMPACTS (1985)

(thous. of jobs)

Nutritional Assistance Program	20.0
Food Stamps	14.9
Developmental Employ. Program	90.0

However there is no doubt that some of the programs included in the G.A.O. Report could imply substantial benefits to the Island social needs. This is the case of



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Medicaid. An increase of 326 millions of dollars in Federal transfers related to Medicaid, could have important implications for the quantity and quality of medical services offered in Puerto Rico. In fact, the increase in Medicaid benefits imply an increase of 37% in total medical expenditures in the Island. These expenditures amounted to 930 millions of dollars in 1986. These services are very labor intensive and for this reason an increase of 326 millions of dollars in these activities would have some important effects.

EMPLOYMENT IN THE HEALTH SECTOR (1984)

(thousands)

Hospitals	35.6
Laboratories	2.7
Other Professionals	<u>4.6</u>
	42.9

This level of direct employment generates a total employment of 62,628 jobs. It is estimated that an increase of 326 millions in these services would generate a total of 28.5 thousands jobs.

However, it is clear that the positive impacts of the increased benefits are not comparable with the economic damage that could be caused by the extension of Federal tax legislation to the Island.

# Comments From the Resident Commissioner of Puerto Rico

JAIME B. FUSTER  
PUERTO RICO

DIAMETER OFFICE  
1423 LONGWORTH BUILDING  
WASHINGTON, DC 20515  
(202) 226-2815

DISTRICT OFFICE  
P.O. BOX 4781  
OLD SAN JUAN, PR 00902  
(809) 723-6333



## Congress of the United States House of Representatives Washington, DC 20515

COMMITTEES  
BANKING, FINANCE AND  
URBAN AFFAIRS  
SUBCOMMITTEES  
HOUSING AND COMMUNITY  
DEVELOPMENT  
INTERNATIONAL FINANCE TRADE  
AND MONETARY POLICY  
GENERAL OVERSIGHT AND  
NEGOTIATION  
INTERIOR AND INSULAR AFFAIRS  
SUBCOMMITTEES  
PUBLIC LANDS  
NATIONAL PARKS AND  
RECREATION  
MINING AND NATURAL  
RESOURCES

April 28, 1937

Hon. Fortney Stark  
US House of Representatives  
1125 LHOB  
Washington, D.C. 20515

Dear Congressman Stark:

I appreciated very much getting a copy of the GAO draft report:  
"Welfare and Taxes: Extending Benefits and Taxes to Puerto Rico..."

Even without studying it concientiously, it is easy to identify serious flaws in its contents which render it very misleading. A major difficulty with the draft report is that its statistics are outdated and do not take into account the effects of last year's Tax Reform Act, which changed corporate taxes both in Puerto Rico and in the mainland significantly. The study also skews its main findings by not giving sufficient weight to countervailing factors that are acknowledged in other parts of the report. This is particularly true about the general finding that new federal income would be higher than new costs if the premises on which the study is based were to come about.

The major flaw in the study's approach is its limited parameters and lack of in-depth analysis. For example, the study does not include all the basic federal assistance programs in which the insular jurisdictions participate inequitably. A prime example is Title I of the Primary and Secondary Education Act which provides students from the island much less help than the one received by those in the mainland.

Moreover, the study does not explore important differences in the treatment of the various insular jurisdictions. For instance, it does not reflect upon the fact that federal per capita disbursements in Guam are as high as \$5004.93 whereas in Puerto Rico, the amount is only \$1834.87.

Likewise, although the study recognizes that extending the whole federal fiscal system to Puerto Rico would seriously affect Puerto Rico's economic situation, raise controversial legal problems and might even affect the political relationship between the island and the U.S., it does not explore these conclusions nor their implications in any adequate or extensive manner.

Other major areas in which the report could be considerably improved are the following:

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1. The study seems to assume that equal treatment for the insular jurisdictions under federal programs would compensate for the multiple effects that would result from their loss of local fiscal autonomy. There is no analysis of the significant social, economic and political costs that would arise not only for Puerto Rico but for the U.S. as well. For example, what will happen to Puerto Rico's huge external debt is not touched upon at all.
2. The study has a jaundiced view about the consequences of eliminating Section 936 of the IRS code since its analysis is very incomplete. It assures that the negative impact on Puerto Rico's industrial possibilities should the tax incentives be terminated could be compensated by other advantages, without discussing at all whether Congress would in fact enact such other advantages.
3. The study is silent regarding the causes and effects of the unreasonable application of some federal standards to Puerto Rico. It does not measure how the island's economic development has been hampered by federal action such as the imposition of the federal minimum wage, the indiscriminate application of environmental and immigration laws, etc.
4. There are also technical aspects of the study which need to be verified, such as:
  - a) The level of the estimated funds Puerto Rico would receive under federal assistance programs seems unduly low. For instance, under the Nutritional Assistance Program, Puerto Rico would be slated to receive \$1159 M and not \$1036 M, as GAO reports.
  - b) Quotes ascribed to Puerto Rican government officials (pps. 50 and 52) may not reflect the official Commonwealth government position.
  - c) The description as to how federal fiscal laws apply in Puerto Rico does not seem to be precise.

This is just a sample of some of the flaws we have found. I can assure you there are many others. In view of this, I would appreciate that you ask GAO to give ample time to representatives of the Commonwealth of Puerto Rico so that they can present their views

Now on pp. 35-39.

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unconstrained by rigid time limits. It would also help if you could ask GAO to review the document and do a more complete and profound analysis of the issue. I would appreciate your assistance in this matter very much.

Yours sincerely,

*Jaime B. Fuster*  
Jaime B. Fuster  
Member of Congress

# Comments From the Governor of the Virgin Islands of the United States



THE VIRGIN ISLANDS OF THE UNITED STATES  
OFFICE OF THE GOVERNOR  
CHARLOTTE AMALIE, ST. THOMAS, V. I. 00801

May 7, 1987

Mr. Richard K. Fogel  
Assistant Comptroller General  
United States General Accounting Office  
441 G Street, NW  
Washington, D. C. 20548

Dear Mr. Fogel:

Please accept my appreciation of your invitation to comment on a draft report by the GAO on extending welfare benefits and taxes to Puerto Rico, Guam, American Samoa, and the Virgin Islands. This letter is my official response, which I understand will be included in any final report of the GAO.

The lengthy draft report (GAO/HRD-87-60) was made available to me for review in advance of publication. I understand it was prepared at the request of the Chairman and Ranking Member of the House Ways and Means Subcommittee on Public Assistance and Unemployment Compensation. It analyzes a Congressional proposal to fully extend certain federal welfare programs to Puerto Rico and the territories and to collect and retain in the U. S. Treasury federal income taxes in these areas.

Your report politely points out the devastation such a tax-retention scheme would have on these off-shore economies. But for me, the consequences on the entire way of life of the people of the Virgin Islands would be so great that it is difficult to accept the idea realistically, much less calmly or politely. I am vehemently opposed to the tax-retention plan.

Appendix X  
Comments From the Governor of the Virgin  
Islands of the United States

Mr. Richard Fogel

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May 7, 1987

What would cause Representatives of the United States to propose siphoning off 60% of the annual revenues of the Treasury of the Virgin Islands? Is it the difficulty inherent in treating territories differently than states? Is it a goal of equalizing federal treatment of states and territories? The quid pro quo of this proposal seems to be: in exchange for the more generous stateside welfare programs, the federal government keeps territorial income taxes.

I do not intend to get drawn into a discussion over whether dollar-for-dollar the Virgin Islands gains or loses under the exchange. I do not even intend to underscore or detail the obvious: that if you eliminate 60% of the operating funds of this Government, there will be thousands more Virgin Islanders applying for those federal welfare programs. Nor do I believe anything like 60% of our current revenues can be made up locally through new or increased taxes without the same result: thousands of people losing their jobs with nowhere to turn but welfare.

What I do want to discuss is the relationship of the Virgin Islands to the United States, the frustrations involved in that relationship, and the effect of the current proposal on that relationship. While these matters were touched on in the draft GAO report, particularly through the remarks of local public figures in response to the U. S. retaining income taxes, they are basically brushed aside in favor of statistical data; i.e., how much would these programs cost, how much can be collected, etc. But isn't there a more important question involved? Can the United States keep the income taxes of territorial citizens simply because Congress decides to do so? Are there no legal impediments to this proposal?

I like to believe that most members of Congress struggle with the idea that the United States "possesses" another land and its people. Somehow it seems to run against the grain of democracy. But, nevertheless, that is what the Virgin Islands is: a possession of the United States, purchased from Denmark in 1917 for \$25 million (in gold coin).



Appendix X  
Comments From the Governor of the Virgin  
Islands of the United States

Mr. Richard Fogel

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May 7, 1987

Of course, we are now United States citizens. But we are also Virgin Islanders. This duality is not the same as, say, that of a resident of Texas who is both a U. S. citizen and a Texan; for as a Texan he is an important part of the union of states. What powers the states have not given to the Federal Government are retained by the states. Virgin Islanders have given the Federal Government no power, and they only have such power as is given them by the Federal Government. It is an important difference. The Federal Government may tax the citizens of the States because those citizens have consented to be taxed. Virgin Islanders have no way of giving consent or affecting tax policy if they had consented.

Forgive me if these remarks seem elementary or at all patronizing. They may be so fundamental as to be taken for granted by a U. S. citizen who has never lived in a territory. But the federalism you take for granted is sorely missed by those of us in the Virgin Islands who do not have it, particularly at times like these when we are faced with a proposal to retain all of our income taxes in the U. S. Treasury and no way to influence that proposal through our own vote in the Congress of the United States.

It seems to me that if Congress desires to make welfare programs and taxes "more comparable" between the offshore areas and the states, then the basic difference between these areas and the states must be addressed. The Virgin Islands is an "unincorporated Territory". By definition, the laws of the United States are not automatically extended to the Territory. "In adopting the Revised Organic Act of the Virgin Islands in 1954, Congress made clear that although it was providing a detailed frame of government for the Islands this was not to be taken as an indication that it had destined the territory for statehood...". Smith v. Government of the Virgin Islands, C.A. 3d 1967, 6 V. I. 136, 375 F. 2d 714.

If the desire of Congress is to make the burdens and benefits of the Federal Government applicable to the Territories in the same manner as they are to the states, then the Territories must be given the same representation in the

Appendix X  
Comments From the Governor of the Virgin  
Islands of the United States

Mr. Richard Fogel

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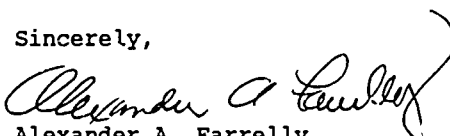
May 7, 1987

Federal Government as the States. It's not that the Virgin Islands is ungrateful for the benefits; it's that we want to be fairly represented through our own vote on the amount of burdens.

My response to the proposal that income taxes of the people of this Territory be retained in the Treasury of the United States is as vehement and indignant as those "Indians" in Boston Harbor over 200 years ago: taxation without representation! As the Governor of an unincorporated Territory I may have no legal grounds to stop the greatest democracy on earth from imposing an income tax on the inhabitants of one of its possessions. But I shall continue to use every means I have to persuade the Congress that it is wrong. It is wrong because it will devastate our economy. And it is wrong because it is blatantly undemocratic.

The Virgin Islands can and shall be a showpiece of democracy among Caribbean nations. Our relationship to the United States is very visible and often envied. We are economically and democratically advanced in the eyes of our "down island" neighbors. We represent local government by the consent of the governed. We are learning democracy through our close association with the United States. Perhaps nothing could be more damaging for U. S. relations in the Caribbean than Federal retention of income taxes imposed on the people of this Territory. Even if there were a miraculous cure for the immense economic ills of this proposal, it still flies in the face of government by the consent of the governed. Taxation without voting representation is as repugnant now as it was to the drafters of the Declaration of Independence.

Sincerely,



Alexander A. Farrelly  
Governor

# Comments From the Speaker of the Guam Legislature



## OFFICE OF THE SPEAKER

Nineteenth Guam Legislature

POST OFFICE BOX CB-1

TERRITORY OF GUAM

U.S.A. 96910

FRANKLIN J. ARCEO QUITUGUA  
Speaker

Tel: 472-3401/3

May 7, 1987

Mr. Richard Fogel  
Assistanat Comptroller General  
U.S. General Accounting Office  
Washington D.C. 20548

Dear Mr Fogel:

Hafa Adai from Guam, and Si Yuus Maase for extending to us in Guam the opportunity to comment on the draft report prepared by the General Accounting Office entitled Welfare and Taxes: Extending Benefits and Taxes to Puerto Rico, Virgin Islands, Guam and American Samoa.

I am pleased that the House Ways and Means Subcommittee on Public Assistance and Unemployment Compensation saw fit to address this very important issue affecting the insular areas. For many years those of us from the islands have stressed the need for appropriate treatment with respect to taxation, and equitable treatment by social programs of the federal government. I trust this report, and the requested comments from the islands, will be the basis for recommendations to establish clear policy goals on these issues.

The report generally sums up the factual information on Guam's existing state of affairs with respect to the issues of taxation and welfare benefits vis-a-vis the federal government. Specific comments on the

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presentation of this data is presented in attachment 'A' (Figures used hereafter are those estimated by the GAO report, even where those figures may not necessarily be agreed to). However, Guam's unique historical and economic conditions seem to be slighted by the draft report. These are basic issues which I feel need to be recognized.

Guam's social, economic, and political development since World War II has been established by Executive, Legislative, and administrative fiat at the federal level. The most significant of the changes was the land use policy of the military forces. Federal land use at the end of WWII was over 40% of the island of Guam. This land use policy ended our subsistence agrarian economy which had provided the Chamorro people self-sustenance since prehistoric times. Our agrarian economy was replaced by a monetary economy, canned goods, and other imports.

Unfortunately, our dependence is not an easy one to escape. Between 1945 and 1962, Guam was a "closed port". Even though our economic base had been changed, we were at a loss to become a part of the new economic order. Even after 1962 - when Guam's doors opened to the flood gate of investment which continues to this day - federal land use policies, and far reaching federal legislation has stymied our growth.

These changes in our social and economic order were in many cases beneficial. The benefits of infrastructure, health, and education have been clearly evidenced. However, our dependence on outside sources of supply, and new standards for social development, have ended our self-sufficiency. From our point of view then, our dependency - which is an immediate result of changes engendered by federal policy - is

compensated for by federal assistance.

In contrast to the statements in the introduction of the draft report, I would like to point out that we do not necessarily need federal assistance because of our distance from world markets, or our limited investment capital, or our scant resources; but rather, because of impediments to our growth as a result of federal policies. The Jones Act and the like keep us from efficiently trading with our Asian neighbors; Commerce and Navigation Treaties between the U.S. and Japan prevent affirmative action in employing our local people in Japanese ventures here; federal funding for marine and sea bed resources is declining; and inefficient federal land use on nineteen (19) separate installations prohibit the potential utilization of our limited physical resources.

Additionally, I must take exception to the statement in the introduction of the report which notes that "...the U.S. has contributed to the social development of the areas by extending federal assistance programs. It has heavily supported schools, hospitals, housing and infrastructure projects." Certainly federal funding for schools has been regular, but a perspective of the issue of federal funding for federally connected students (Deficiencies in Federal Funding for Federally Affected Students - attachment 'B') illustrates federal dependence on the Government of Guam for the education of such transient students. The Government of Guam annually subsidizes the operations of our autonomous hospital, largely to compensate for bad debts of indigent patients - patients who would have funding if Medicaid was fully extended to Guam. Federal support for Guam's infrastructure has been sporadic, and addressed on a piecemeal basis. Over half of the island still has regularly interrupted power and

water service, further compounding health problems. If Guam's schools, hospital service, and infrastructure have been "heavily supported" by federal assistance, the local government - with limited resources and enormous restrictions on development - has done more than its share to ease the social change brought on by federal policies toward Guam.

I believe that the report would be remiss if it did not recognize the very difficult conditions which Guam has faced in the transition from an agrarian subsistence economy to a monetary economy. These changes were, after all, the result of federal policies toward Guam. Radical social change, restrictions on access to the new social order, subsidies for the education of transient federally connected students, continuing immigration and piecemeal federal support for infrastructural improvements have generated an immense snowball effect subverting Guam's ability to help itself. While federal assistance has in many ways increased our dependence, we are powerless to meet the needs of our people without it. Certainly an enhanced level of funding for the social programs identified in the report would assist the government in meeting the many needs of our residents, and help to reduce our deficit by supplanting local subsidies for programs that would be better funded if full federal program benefits were extended.

Even the full extension of benefits will not have the same fiscal impact on recipients in Guam as they would on stateside recipients. Our cost of living is exasperated by the cost of transporting goods vis-a-vis our relatively small population. Ninety eight percent (98%) of our daily needs are imported, and our power costs are some of the highest in the U.S..



Adult Assistance under the Supplemental Security Income program is a program long overdue to Guam. The report's estimate of a 700% increase in benefits to Guam residents if the program was fully extended, is in itself indicative of our need. As our culture's extended family system is gradually being eroded, we are increasingly dependent on funding to address the needs of the aged, blind and disabled. Moreover, there is a seething anger on Guam because this program is not already in place - especially when such benefits are available to our neighbor islands, the Commonwealth of the Northern Marianas. As a legislator for the past 10 years I have many times been at a loss to explain to the parents of handicapped individuals, how they are to cope with the real costs, and absence of opportunity for their children. Of course these problems are doubly compounded when the parents themselves are dependent on various forms of social assistance. In my experience, I have known families to leave Guam, for other destinations in the U.S., just to qualify for these benefits.

The extent to which the report notes Aid to Families with Dependent Children (AFDC) would increase is again illustrative of our social conditions, and the need for further assistance. Again the effects of social change are clearly evident in this area. High rates of teen pregnancies and /or parents unable or unwilling to support their children, is a phenomena known to Guam only in the past twenty years. This alone seems justification for full benefits. The projected increase in benefits of approximately 250% if the program were to be fully extended, together with the projected increase in Child Support Enforcement funding, would assist local measures which have placed a stiff legal (PL 18-17) mandate that child support be paid by the responsible parties.

We would, of course, welcome federal support for preventative programs aimed at addressing the ongoing problems of social change which many youth are frustrated by. Of course teen pregnancy is not the only area that would be effected by better funded prevention programs. Attempted suicides for example numbered 238 recorded attempts in 1985. However, additional emphasis on prevention, should assist in reducing long term costs of programs such as AFDC, and Child Support Enforcement.

Medicaid is a program that will affect almost six thousand (6,000) new participants if it were fully extended. This represents approximately 5% of the island's population. Local support for the Medically Indigent Program is over Two Million Dollars (\$2,000,000) annually, and even this amount is acknowledged to be One Million Dollars (\$1,000,000) below the low estimate of this program's needed funding level.

The Guam Memorial Hospital (GMH - an autonomous agency of the Government of Guam) has had, and is continuing, rate hikes which will raise the hospital's rates nearly 100% in a eight year period. However, even this has not satisfied GMH's revenue needs. Supplemental funding of GMH occurs annually to the tune of a round Five Million Dollars (\$5,000,000). There are admitted problems of internal mismanagement, but the cost of absorbing bad debts from indigent patients, and self paying patients who are not categorically "indigent", is the most notable inadequacy of the hospital's funding shortfall. 'Self pay' patients billings are discounted 70%, and even indigent billings are discounted 36% by the Guam Memorial Hospital.

This year the Department of Revenue and Taxation is holding all individual tax refunds until a clearance of hospital billings is obtained by patients who owe the hospital. Garnering payment from indigent patients is a difficult process, but the above example does demonstrate the level of local vigilance. Clearly, the projected Three Million Eight Hundred Thousand Dollars (\$3,800,000) in additional benefits with the full extension of this program, would greatly assist GMH in funding operational and capital improvement costs. It would additionally reduce the existing Government of Guam subsidy for hospital operations which is a continuing deficit expenditure.

Increased federal support for Foster Care and Child Support Enforcement programs with the removal of the AFDC ceiling, would be pursued by the Government of Guam. Additional federal funding, in support of our local laws on child support payments, would further the full implementation of our statutes.

Guam's participation in the Food Stamp program again shows our dependence on federal assistance to meet the basic needs of daily living. However, it is one of my personal goals to see Guam's Food Stamp program replaced by a block grant program which requires that a percentage of the amount was designated for the purchase of locally produced or manufactured foods. The Governor, the Director of Public Health and Social Services and myself recently met with USDA and food stamp program officials in Washington D.C. and San Francisco about our desires. We are now in the process of preparing our proposal for Region IX officials' review.

As the primary motivation for moving the food stamp program to a block grant is to give us the flexibility to promote local produce through federal assistance, the need to resolve federal land use inefficiencies is greater than ever. Through the transfer of the food stamp program we hope to stimulate a consistent agricultural industry which provides employment, delivers fresh healthy foods, and reduces our dependence on outside sources. Inevitably the need to cultivate larger parcels of land will encroach on the existing land holdings of the federal government. Tens of thousands of acres of "needed" land are unused, and several thousand acres of "excess property" identified by the Department of Defense have not been returned. It is certainly time for a Congressional review of the federal government's land needs on Guam.

On the issue of our area income tax becoming part of an extended federal income tax, I believe the early American colonists objection to "taxation without representation" perfectly sums up Guam's position. Guam residents are not allowed to vote in U.S. presidential elections, and our Congressional delegate is without voting powers on the floor of Congress. The track record of Guam's civilian community in securing funding for the needs of the island is not good. Simply put, Guam is without political clout in the nation's capitol. The elected leaders of the federal Congress have their own constituency to care for first. Hence, we cannot rely on the powers that be to provide representation of the island peoples interests with any consistency.

If the area tax were to be extended to the federal income tax system, the disastrous effect on our economy, and the subsequent short fall in local revenues to meet local needs, would generate extensive social trauma.

Already Guam is forced to forego millions of dollars in potential revenues due to: commissary and base privileges subsidized by U.S. taxpayers, and abuse of these privileges because of the huge price differential of goods compared to the civilian sector; security restrictions on the development of private property; non-taxable defense activities which are situated on property with immense development potential; supplies and materials for military activities purchased in the U.S. mainland and shipped to Guam on military ships; and the list goes on. Moreover, the right of the Government of Guam to utilize its area tax was established in Guam's original Organic Act - as enacted by Congress. It is clear that any attempt to discontinue local redistribution of the taxes identified in Section 30 and 31 of Guam's Organic Act, would have far reaching economic, social, and political repercussions.

The Government of Guam's right to grant local rebates as incentives for economic development are important to our island. While there have been abuses in the past, there is no denying that the rebates have positive effects on attracting investors to Guam. Although the rebate program is suffering some pains of abuse, there are investigations underway, and the new administration seems sincere in redressing the use of the program.

Guam is also working toward delinkage from the federal tax system as was provided for in the 1986 Tax Reform Act. While the 1986 gubernatorial election, and the early 1987 efforts to address the Government of Guam's deficit have moved planning for delinkage off the front burner, the Legislature is cognizant of, and generally supportive of the delinkage approach.

While my comments have responded generally to the issues of fully extending welfare programs and Guam's need to redistribute its area income tax, these programs in themselves are not seen as an end all to needed federal assistance. Indeed, there are many ways in which the welfare programs further dependency, and react, rather than solve social problems. All the insular areas cited in the report are islands, and as such have different environment, and needs than jurisdictions in the mainland United States.

In most instances, the existing dependency on federal assistance is a result of federal policy. This dependency would then be better addressed by federal assistance which: (1) recognized the limitations on self-sufficiency placed on the islands by the federal government, and subsequent provisions for a comprehensive infrastructure plan which would allow for consistency in planning and development of infrastructure needs; and, (2) allowed for the maximum utilization of such assistance to further measures of self-sufficiency, by allowing for more local control over the use of assistance. The Guam Legislature's Federal, Foreign, and Legal Affairs Chairman has twice this year proposed to Congressional committees a comprehensive planning approach as is mentioned above in item 1. In the case of the latter item, the Office of Technology Assessment in its report on Integrated Renewable Resource Management for Insular Areas has proposed a rationale to allow for federal assistance to be molded to suit the uniqueness of the island environment. I believe that combining the two approaches would significantly boost the viability of the local economy, and began to address the social problems which have resulted from the dramatic social change and dependency which prevailed for many years.

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I trust that Congress sees the wisdom of assuring the people of Guam that Uncle Sam is not only on their island, but that he is also on their side.

Sincerely,

  
Franklin J. Arceo Quiugua  
SPEAKER

SPECIFIC COMMENTS ON DATA AND ASSERTIONS  
OF THE DRAFT REPORT

Recognizing that the GAO is confronted with a difficult task, in making general comments about the conditions and history of the the insular areas as a group, the report still falls short in taking note of Guam's unique development vis-a-vis that of other insular areas. If one specific example of differences in development could be cited as making Guam distinctly different than other areas it would be the presence of the U.S. military forces.

Now on p. 10.

In Chapter 1 (Introduction) p. 14, references to inhibiting factors of insular development do not necessarily suit Guam. This is referenced in the letter to Mr. Fogel. However, the report would be remiss if it did not additionally recognize the federal land use policies and activities as an inhibiting factor to our islands' development. Land use itself is a huge barrier to our development. But military requirements and special cost treatment for utilities and telecommunications access and use, also negatively affects civilian consumer and business development costs. (see: A Paper Delivered to Congress on Guam's Electric Utility From Its Inception to the Present, Sixteenth Guam Legislature, Committee on General Governmental Operations, 1982)

Now on p. 11.

References on p.15, to federal support for "schools, hospitals, housing, and other infrastructure projects" is in part addressed by attachment 'B', after the cover letter. The assertion that "Long-standing federal policy... has aimed at fostering the areas' fiscal autonomy and economic

self-reliance" is something that federal policy has not done, unless the reference is only to special treatment for our limited ability to garner taxes through the area tax privilege of Sections 30 and 31 of the Organic Act of Guam. However, even this "privilege" does not represent federal policy aimed at "fostering fiscal autonomy" or "self-reliance" in the eyes of most residents. Not only is it socially, economically, politically (and geopolitically) necessary for Guam to redistribute its own taxes, but there are many limitations on our ability to enhance our tax base due to federal land use activities.

Now on p. 12.

Table 1.1 on p.16, is one of the most flagrant flaws of the report's presentation as it relates to Guam. The draft report even vindicates this point through several inconsistencies of its own.

The inclusion of military salaries as a part of the per capita income skews the real per capita income upwards, and reduces Guam's percentage rate for funding eligibility in the AFDC program, which is a benchmark for other social programs. From a local perspective the military is largely responsible for the changing social conditions of the island. To include military salary as part of the island's per capita income fails to recognize the insulated and artificial economy that military spending has generated. With military contingencies for Guam slated to bring in thousands of additional personnel, the per capita income would be skewed higher still - again ignoring the problems of development the military itself has placed on our private sector development.

Recipients of military salaries are "imported" labor, and as such use of their salaries should be excluded from Guam's per capita income level.

Military salaries are part of an unstable economy which local market factors have no control over.

The Department of Commerce has established (recently adjusted) per capita income for the civilian sector in 1984 (including civilians paid by federal agencies) at \$7,504. This figure would be more appropriate to use in reflecting Guam's needs for social programs. While many local residents join the U.S. military, their numbers do not match the number of active duty personnel on Guam. Moreover, one cannot be employed in the military on Guam per se, but rather one is assigned to Guam by the military. Therefore, use of military employment as a factor of the island's unemployment rate is inappropriate. The fact that the inclusion of military salaries increases Guam's per capita income illustrates the lethargy of our locally generated salaries.

Now on p. 58.

The report notes on p. 79 that "...the large military presence would tend to stabilize personal tax revenues because military pay is not dependent on the island's economy..." illustrates the above mentioned points.

Now on p. 112.

The footnote (8) on p. 171 again shows how inclusion of military salaries in Guam's per capita income skews participation levels and reduces participation for local residents. Although the reference is to SSI benefits, the rationale can be easily applied to ceiling limitations for Guam's participation in the AFDC program. The footnote reads: "We used civilian population for Guam because of the large number of U.S. active duty personnel on the island, most of whom would not qualify for SSI benefits"

The reference to Guam's per capita income on p.176 clearly shows the

impact of including military wages in Guam's per capita income as it applies to federal assistance ceilings. The report notes that Guam's participation in Medicaid would be 2.41% below Puerto Rico, the Virgin Islands and American Samoa, because of Guam's higher per capita income. Since this higher per capital income for Guam is actually the result of including military pay - thereby increasing the per capita income by \$900 - clearly the use of military pay reduces the benefits of the welfare programs available to those who are already subject to disadvantages vis-a-vis the military.

Now on p. 16.

The report's notation of the Department of Interiors, International and Territorial Affairs Office (ITAO) role with respect to the territories (p.22) is far too idealistic and should be reworded. It is hardly correct to say that the ITAO "presents and defends the areas' budgets before Congress, and promotes the economic, social and political development of...Guam..." The International and Territorial Affairs Office is very much a political office, and the officials in charge have little choice but to support the wishes of the appointing authority. Besides the fact that the territories provide little or no input on ITAO's budget presentation, Congress has (of late particularly) seen fit to substantially increase the budget amounts which ITAO has recommended.

Now on p. 58.

One last technical correction which should be made to the draft report is at the bottom of p.79. The reference to military personnel obtaining goods from civilian suppliers as a stabilizing affect on the economy, ignores the unfair competition Guam's private sector retailers face from militaries subsidized stores. The Guam Chamber of Commerce has estimated that Navy's commissary sales alone would generate an

additional \$20,000,000 in Gross Receipts Tax (4%) annually. While some military expenditure does occur in the civilian sector, basic goods are generally purchased on base where prices are significantly lower.

# Comments From the Governor of American Samoa



**TERRITORY OF AMERICAN SAMOA**  
OFFICE OF THE GOVERNOR  
FAGATOGA 96798

A. P. LUTALI  
GOVERNOR  
ENI F. HUNKIN, JR.  
LIEUTENANT GOVERNOR

(864) 635-4116

May 21, 1987

Serial: 952

Richard L. Fogel  
Assistant Comptroller General  
United States General Accounting Office  
Washington, D.C. 20548

Dear Mr. Fogel:

Thank you for the opportunity to comment on the draft report "WELFARE AND TAXES: Extending Benefits and Taxes to Puerto Rico, Virgin Islands, Guam, and American Samoa," prepared by the staff of the United States General Accounting Office for submission to the House Ways and Means Committee, Subcommittee on Public Assistance and Unemployment Compensation. I wish to commend the staff who prepared this report. It is a well written document, but more importantly it has been written with considerable thought given to the economic, social, and cultural impacts of extending benefit programs and federal income taxes to the four areas.

My comments on this report is limited to the scope of work performed in American Samoa. To begin, I wish to state that the report is correct, in that, of the six welfare programs investigated (SSI, AFDC, MEDICAID, FOSTER CARE, CHILD SUPPORT ENFORCEMENT, FOOD STAMPS), Medicaid is the only program available to the Territory.

As indicated in the GAO report, American Samoa participate in the Medicaid Program under unique circumstances; and therefore, it is not perceived as a welfare program, but as a revenue measure for our health care delivery system. The GAO report correctly assesses the effect on the Territory of fully extending the Medicaid Program to American Samoa. I feel that the present arrangement, whereby American Samoa is able to receive the financial benefits of the Medicaid Program without the burdensome administrative and reporting requirements and the necessity of identifying Medicaid eligible persons individually, is in line with our needs for assistance in this area.



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There is a preponderance of documented evidence to justify raising the Medicaid cap for American Samoa by a least \$400,000 annually. Our Health Care Financing Administration combined Medicare/Medicaid Cost reports and annual Presumed Eligible Population Reports contain the information which justifies this need. The existing Medicaid cap prevents American Samoa from being reimbursed for the full amount of Federal Medicaid funds for which the Territory would otherwise be eligible.

The GAO report estimates that if the welfare programs had been fully extended in 1984, federal costs would have increased \$22.6 million and American Samoa's costs would have decreased \$460,000. The programs would have provided substantial federal funding to the Territory. I believe however that the implementation of the programs and funding would have come at a very high cost. A cost which would have destroyed the values of our culture, traditions, and extended family network. A cost which would have created welfare dependency and work disincentives. A cost portraying American Samoa as a welfare state which is contrary to our desires and efforts to become less dependent on the United States tax dollars.

The GAO report indicates that approximately 21,000 participants in American Samoa would be eligible for Food Stamps under the present federal system. This is approximately two thirds or sixty percent of our current population. What state or U.S. possession has two thirds of its population as welfare recipients?

While it is true that area cost would decrease and more benefits would be made available to more people with the extension of these benefit programs, it is not true that it would eliminate our economic and social problems. One of the major concerns is the influx of alien immigrants to the Territory seeking to benefit from these welfare programs. American Samoa is presently experiencing severe economic and social hardships with its alien population. Our schools lack adequate educational facilities. Our sole hospital has similar physical problems. Our prison which was constructed to accommodate fifty prisoners is presently housing eighty-seven with the majority being non-residents. Our alien labor force has grown substantially in the last few years. I fear that the availability of these welfare programs may increase alien immigration and further compound some our economic and social problems.

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I also believe the extension of federal income taxes to American Samoa may produce economic and social hardships. Presently, 75 percent of individuals pay the local 2 percent minimum tax. The draft report estimated that American Samoa collected about \$633,000 more in personal income taxes for 1983 than the federal government would have collected. In 1986, American Samoa collected an estimated \$2,228,861 more in personal income taxes than the federal government would have collected. This is due to the changes in the tax laws over the last three years. With the Tax Reform Act of 1986, the future figures could be lower because of increased deductions for dependents and the increase in the standard deduction.

Had Federal income taxes been fully extended to American Samoa corporations in 1983, the revenues would have been \$9.7 million instead of the \$8.9 million as reported in the draft report. For 1986 corporate revenues would have been \$7.4 million. The decrease is due to one cannery not showing a profit for the last three years. Corporate tax rates were also reduced in the 1986 Reform Act. This reduction will decrease actual revenues by an estimated \$.5 million.

The two canneries account for 90% of all corporate taxes in American Samoa. Both canneries have expressed opposition to extending federal income taxes to American Samoa. One cannery stated that if federal taxes were extended to American Samoa, its management would be forced to reevaluate its position, and that there would be a high probability of relocating to more favorable economic locations.

Although the extension of federal income taxes in American Samoa would gain the federal government additional revenues, it would, in the long run, be self defeating from a federal and local standpoint. The imposition of federal taxes would result in the decrease of area tax revenues which would certainly undermine our efforts to become economically self-sufficient. The elimination of tax credits and local tax exemptions would make American Samoa less attractive to corporations currently operating in the Territory and to outside investors. This, too, would undermine our economic development efforts. It is fair to assume that with the extension of federal taxes, business activity would reduce substantially, unemployment would rise and ultimately federal tax revenue would decrease. If it is the intent of Congress to increase federal dollars by imposing federal income taxes to American Samoa, I believe in the long run this objective would be defeated. In the same regard, it would also defeat our objectives to promote economic development and to move towards a more self sustaining state.

Appendix XII  
Comments From the Governor of  
American Samoa

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I hope the members of Congress, prior to taking any final action on the report, take into consideration the facts presented in the report and the views expressed by the officials of Puerto Rico, Virgin Islands, Guam, and American Samoa.

Thank you for the opportunity to comment on the report.

Very truly yours,

  
A. P. LUTALI  
Governor

APL/mtl

# Comments From the President of the Senate of American Samoa



AMERICAN SAMOA GOVERNMENT  
OFFICE OF THE PRESIDENT OF THE SENATE  
LEGISLATURE OF AMERICAN SAMOA

LETULI TOLOA  
President

Serial:052-87  
LT/mtv  
Tel: (684) 633-4565  
633-5231

May 7, 1987

Mr. Richard L. Fogel  
Assistant Comptroller  
General Accounting Office  
Human Resources Division  
Washington, D.C. 20548

Dear Mr. Fogel:

This responds to your March 27 letter and draft report regarding the extension of certain federal taxes and welfare programs to the territories. Speaking, of course, only for American Samoa, I concur with the reported responses of officials interviewed here which indicate opposition to the extension of most of these programs to American Samoa.

After reviewing the draft report and the projected impact on federal and local costs of offering these programs, I wish to emphasize facts not thoroughly dealt with in the analysis of our population. Out of the reported population of approximately 35,000, nearly one half of the residents are under the age of 18. Also, it is reported by local authorities that aliens constitute nearly 40 per cent of the population. Obviously, there is an overlap between these two groups, though I do not know its extent. The point is that perhaps an unexpectedly large portion of our population may not qualify at all for any of these programs due to their status as aliens or their age of minority. Moreover, the demographic changes of the next 5 or 10 years may dramatically alter the makeup of the target groups and the resulting costs of servicing them. Therefore, it is premature and risky to implement the programs at this

P. O. Box 485, Legislature of American Samoa, Pago Pago, American Samoa --- 96799

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time until better data can be gathered.

As has been demonstrated in other areas, there is a possibility of serious fraud in the application process for some welfare programs in the territory. With the cultural adaptation of extended family situations, persons can easily report absent spouses, numerous dependent children, lack of household income, and can exaggerate other eligibility criteria to gain the welfare benefits. It is my opinion that this problem would be difficult to control at best and would be compounded by additional immigrants at worst.

Regarding labor statistics, American Samoans able to work are rarely "unemployed" in the cultural sense. Young and old, men and women, all have defined roles in the Samoan society with much of their time spent doing domestic non-paying tasks. These include plantation cultivation, animal keeping, cooking, weaving mats, building fale, etc. These occupations are very traditional and serve to support families, villages and chiefs as well as any cash paying job ever could in terms of cultural accomplishments. Money for wealth is only a recent innovation in Samoa, where wealth is traditionally measured in terms other than material assets.

Extending the full six welfare programs would reportedly be a cost savings to the Territory of only about \$400,000 per year. While we appreciate every opportunity to save expenses, such an amount is not overwhelming and we are not at all compelled to opt for such gains in comparison to the risk of much larger disadvantages.

What will benefit this territory far more than welfare programs is a more diversified economic base. In such a small economy, the impact of new businesses is felt quickly and the economic gains do in fact ripple across the island.

On the issue of extending federal income tax to American Samoa, the draft report is accurate as to the likely adverse effects of weakening or removing certain tax incentives. The tuna canneries are our economy and there is no doubt that this island would be devastated if they pulled out or substantially curtailed their production. I strongly oppose any change in the application of federal corporate tax law to the territory which would encourage the canneries to leave or cut back their operations, particularly section 936 of the tax code.

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Perhaps the extension of additional business incentives would be better. The long run effect of more tax generating firms would not only increase tax revenue but decrease the number of persons in need of welfare support. Simple economics works well in American Samoa.

Although the income levels in dollar terms are comparatively low here, the wealth of our social and cultural system more than adequately provides all basic needs, with one major exception; medical care. Given our small population, we will always be strained financially to support a modern hospital with current health care technology. Medicaide payments which assist in obtaining or providing health care services to medically needy persons will likely always be acceptable here. Already we refer a large number of residents off-island for medical services at the government's expense. Monetary distributions directly to the medically needy may encourage them to seek private medical care and help them defray other costs of living related to their condition.

Thank you for the opportunity to respond to your proposed report. If I can be of any further assistance, please let me know.

Sincerely,

  
LETULI TOLOA  
President of the Senate

# Comments From the Department of Agriculture



United States  
Department of  
Agriculture

Food and  
Nutrition  
Service

3101 Park Center Drive  
Alexandria, VA 22302

APR 2

Mr. J. Dexter Peach  
Assistant Comptroller General  
Resources, Community and  
Economic Development Division  
U.S. General Accounting Office  
Washington, D.C. 20548

Dear Mr. Peach:

This report responds to your letter of March 27, 1987 requesting comments on your report entitled WELFARE AND TAXES: Extending Benefits and Taxes to Puerto Rico, Virgin Islands, Guam and American Samoa.

My comments focus on those sections of the draft report related to the Food Stamp Program (FSP) and its counterpart in the Commonwealth of Puerto Rico, the Nutrition Assistance Program (NAP). Enclosed are detailed comments to clarify, refine and update particular points made in your draft report.

I believe this descriptive report could be improved if it emphasized the significant current Federal commitment to providing assistance in these outlying areas. While assistance efforts are mentioned, the draft report tends to understate the extent of assistance that USDA continues to provide to low-income persons in the geographic areas discussed. In particular, the draft report acknowledges that Guam and the Virgin Islands participate fully in FSP; however, the report tends to downplay the significant role of Puerto Rico's NAP.

The Nutrition Assistance Program serves approximately one-half of Puerto Rico's population. This single program provides over 80 percent of the total Federal funds channeled to Puerto Rico and the other three areas through the six assistance programs identified in your report.

As mentioned in the draft report, the Food Stamp Program does not operate in American Samoa largely because officials there generally oppose Federal assistance programs. In sum, with the exception of American Samoa, FSP and its NAP counterpart are currently assisting those in need who choose to participate.



Mr. J. Dexter Peach

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The report could also be improved by supplementing the Fiscal Year 1984 program and cost information currently contained in the report with more recent information. I understand that Fiscal Year 1984 is the most recent period for which information is available on all six assistance programs addressed. However, various relevant changes in FSP and NAP have occurred since then. In particular, NAP funding is no longer capped at \$825.0 million. The Fiscal Year 1987 appropriation for NAP is \$852.8 million. Congress has authorized annual funding increases for Fiscal Years 1987-1990. The draft report did not include the current authorization level nor was this Fiscal Year 1987 level incorporated into relevant cost estimates. Only a vague parenthetical reference to authorized increases appears in the text.

I hope these comments as well as those which are attached will help you in more fully describing the commitment which the Federal Government has to assist needy individuals in these outlying areas.

Sincerely,

*S. Anna Kondratas*

S. ANNA KONDRATAS  
Acting Administrator

Enclosure

# Comments From the Department of the Treasury



DEPARTMENT OF THE TREASURY  
WASHINGTON

MAY 11 1987

Dear Mr. Anderson:

I am responding on Secretary Baker's behalf to your request for comments on the draft GAO report, Welfare and Taxes: Extending Benefits and Taxes to Puerto Rico, the Virgin Islands, Guam and American Samoa. The comments we have on your discussion of taxes are:

- (1) The reference to "tax year 1983" is not clear. The corporate tax data used pertain mainly to calendar year 1982 and do not reflect the impact of the 1982 TEFRA legislation which applies to tax years beginning after December 31, 1982. The estimates should therefore reflect adjustment for the impact of TEFRA.

Now on p. 3.

- (2) The assertions on the long run increase in revenue from extending federal taxes to the possessions are highly speculative. (For example, the statement on page 4 of the executive summary that "GAO believes annual federal tax revenue could decline significantly over the long run [compared to the initial, short run, increase] ...") They should be deemphasized and stated in a highly qualified manner. In addition, there should be a fuller discussion of the possible sources of error in the short run estimates.

Now on pp. 56-57 and 132-136.

The discussion on pages 77-79 and 156-160 of the industries that would leave Puerto Rico and move out of the United States altogether if they had to pay full federal tax is not systematic enough to be of any merit. The discussion does not consider the tax cost of transferring intangibles outside the United States.

Now on p. 136.

- (3) On page 150, the report states that "half of 1982 earnings of corporations claiming the credit in Puerto Rico were from intangibles". This presumably is based on the Treasury's Fourth Report on Possessions Corporations. Our current view is that this is probably an underestimate of the significance of intangibles.
- (4) The reference on page 151 to a possible indirect employment "multiplier" of 2.35 should be deleted. The Treasury's Fifth Report explains why this estimate is spurious; the 2.35 estimate has even been disowned by Puerto Rican statisticians.

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- (5) It is not clear why the report does not adopt the state model and assume that possessions taxes are maintained but are deductible against federal liability. Is there any reason for the specific assumptions adopted on local taxes?

Sincerely,



C. Eugene Steuerle  
Deputy Assistant Secretary  
(Tax Analysis)

Mr. William J. Anderson  
Assistant Comptroller General  
U.S. General Accounting Office  
Washington, D.C. 20548

# Comments From the Department of the Interior



## United States Department of the Interior

OFFICE OF THE SECRETARY  
WASHINGTON, D.C. 20240

MAY 13 1987

Mr. J. Dexter Peach  
Assistant Comptroller General  
U.S. General Accounting Office  
Washington, D.C. 20548

Dear Mr. Peach:

On behalf of the Secretary of the Interior, this letter is in response to the U.S. General Accounting Office (GAO) draft report on extending welfare benefits and taxes to Puerto Rico, the Virgin Islands, Guam and American Samoa.

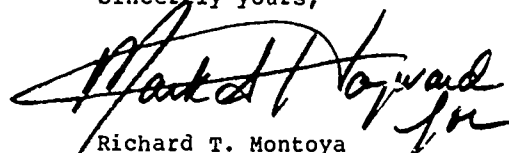
The Department of the Interior, through the Office of Territorial and International Affairs, has administrative responsibility for coordinating Federal policy in American Samoa, Guam, the Northern Mariana Islands, the Trust Territory of the Pacific Islands, and the U.S. Virgin Islands. The mandate of this office is to promote economic, social and political development in these territories.

The Office of Territorial and International Affairs is adamantly opposed to fully extending Supplementary Security Income (SSI), Aid to Families with Dependent Children (AFDC), Medicaid, Foster Care, Child Support Enforcement and Food Stamps, as well as Federal income taxes to the aforementioned areas. It would be difficult, if not impossible, for the territorial governments to meet the matching requirements of these programs. In addition, the bureaucracy that would be created to administer these programs would bankrupt the islands' fiscally as well as morally.

In addition to consideration of the economic impact of these programs on the island governments, we must also look at potential damage to the culture. The Federal government must not be a party to the deterioration of a traditional and tremendously successful extended family concept still adhered to in the territories by offering relief under far less effective and efficient welfare programs.

The Office of Territorial and International Affairs is leading an effort towards self-government for the territories and the active participation of their residents in the determination of their own future. Additional Federal programs would be an intrusion upon these objectives.

Sincerely yours,



Richard T. Montoya  
Assistant Secretary--Territorial  
and International Affairs

# Comments From the Department of Health and Human Services



DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General

Washington, D.C. 20201

JAN 2

Mr. Richard L. Fogel  
Assistant Comptroller General  
U.S. General Accounting Office  
Washington, D.C. 20548

Dear Mr. Fogel:

The Secretary asked that I respond to your request for the Department's comments on your draft report, "Welfare And Taxes: Extending Benefits And Taxes To Puerto Rico, Virgin Islands, Guam, and American Samoa." The enclosed comments represent the tentative position of the Department and are subject to reevaluation when the final version of this report is received.

We appreciate the opportunity to comment on this draft report before its publication.

Sincerely yours,

Richard P. Kusserow  
Inspector General

Enclosure

COMMENTS OF THE DEPARTMENT OF HEALTH AND  
HUMAN SERVICES ON THE GENERAL ACCOUNTING OFFICE'S DRAFT REPORT,  
"WELFARE AND TAXES: EXTENDING BENEFITS AND TAXES TO PUERTO RICO,  
VIRGIN ISLANDS, GUAM, AND AMERICAN SAMOA," GAO/HRD-87-60

General Comments

We appreciate the opportunity to comment on the draft report. We find the report to be a fair and accurate description of the operation of the Department's programs in the Commonwealth of Puerto Rico and the territories and of the consequences of fully extending the Department's programs to these areas.

The report does not provide any recommendations. However--because of uncertainties about the impact of extension of these programs and U.S. tax laws--GAO cautions Congress to consider an experimental approach rather than outright extension. We agree with GAO's concerns and suggest the report provide two additional caveats--

- o First, there are a number of welfare reform proposals being considered by Congress that would substantially alter the programs addressed in the report. These include an Administration proposal to allow states, on a demonstration basis, to exercise broad latitude in determining benefits, eligibility, and program structure for these and many other welfare-related programs.

The report should indicate that the extension of the welfare programs to Puerto Rico and the territories should be addressed as a part of, or subsequent to, congressional consideration of those legislative proposals.

- o Second, GAO should be explicit in recognizing that the extension discussed in the report is only one approach to reforming the administration of these programs. There are other program design options that--because of the concerns and uncertainties cited by GAO--are worth congressional consideration. These include such options as block grants, program waivers, and other approaches that would increase flexibility in determining eligibility and benefit levels. There is precedent for such treatment since there have been a number of instances in which Federal legislation has taken account of the unique circumstances of Puerto Rico and the territories. These include:

- replacement of the Food Stamp program in Puerto Rico by the Nutritional Assistance program;



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Comments From the Department of Health  
and Human Services

- the extension of the Medicaid program to American Samoa; and
- the enactment of the program consolidation provisions of Public Law 95-134.

In each of these cases, it was recognized that Federal programs designed for state operation are frequently not appropriate for Puerto Rico and the territories. Thus, in any consideration of program extension or modification, Congress should examine a full range of options. An important principle in assessing those options should be that Federal agencies, Puerto Rico, and the territories should have broad latitude to design and administer benefits and services in a manner that best meets the needs of the citizens of those jurisdictions.

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